

# DEPARTMENT OF THE TREASURY BUDGET PRIORITIES FOR FISCAL YEAR 2005

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## HEARING BEFORE THE COMMITTEE ON THE BUDGET HOUSE OF REPRESENTATIVES ONE HUNDRED EIGHTH CONGRESS SECOND SESSION

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HEARING HELD IN WASHINGTON, DC, FEBRUARY 4, 2004

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**Serial No. 108-17**

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Printed for the use of the Committee on the Budget



Available on the Internet: <http://www.access.gpo.gov/congress/house/house04.html>

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U.S. GOVERNMENT PRINTING OFFICE

91-688 PDF

WASHINGTON : 2004

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## DEPARTMENT OF THE TREASURY BUDGET PRIORITIES FOR FISCAL YEAR 2005

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WEDNESDAY, FEBRUARY 4, 2004

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON THE BUDGET,  
*Washington, DC.*

The committee met, pursuant to call, at 2:10 p.m. in room 210, Cannon House Office Building, Hon. Jim Nussle (chairman of the committee) presiding.

Members present: Representatives Nussle, Shays, Gutknecht, Hastings, Portman, Brown, Crenshaw, Putnam, Tancredo, Garrett, Barrett, McCotter, Diaz-Balart, Hensarling, Spratt, Moran, Hooley, Baldwin, Moore, Lewis, DeLauro, Edwards, Scott, Capps, Thompson, Baird, Cooper, Emanuel, Majette, and Kind.

Chairman NUSSLE. The committee will come to order. Good afternoon. Today we have before us the Department of the Treasury Budget Priorities for Fiscal Year 2005. Today we have two panels of witnesses. The first witness is, of course, the Secretary of the Treasury, the Honorable John Snow; the second panel will be Henry Aaron, a senior fellow of the Brookings Institute. So we invite the first panel forward and we welcome the Secretary of the Treasury back to the Budget Committee.

Welcome, Mr. Secretary. We are glad to have you here today.

Just before the hearing began, we had a little informal discuss with the Secretary back in the cloakroom, which is why we are starting slightly behind. We appreciate the chance to visit, though, informally. Today we have a lot before us.

Yesterday this committee, Mr. Secretary, heard from the President's Director of Office of Management and Budget, Josh Bolton, about the President's budget request for fiscal year 2005, as well as from Chairman Mankew from the Council of Economic Advisors on the administration's economic outlook.

Today we want to focus on the top priorities that we face, and that is doing whatever we can at the Federal level to ensure that our economy continues to grow and that Americans can continue at increasing numbers to find jobs and go back to work.

Thankfully, we are in a much different position, Mr. Secretary, than the last time you were before us last year. At that point we had seen quarterly GDP growth come in about 2.8 percent. Today we have enjoyed two consecutive quarters of strong growth, with the fourth quarter growth at 4 percent and the third quarter growth at a whopping 8.2 percent, which was the highest surge in GDP in the last 20 years. Consumer sentiment jumped in January, for the highest 1-month gain in 11 years, and to the highest overall

level in 3 years. Manufacturing is soaring, hitting its highest pace of activity in the last 20 years just this last December. Housing starts are at their highest level in 20 years. Mortgage interest rates continue to run at their lowest levels in over three decades and the bank prime rate is at its lowest level in 45 years.

Inflation has been running at its lowest rate in nearly four decades. U.S. real exports of goods and services rose in the fourth quarter at a 19 percent rate, the fastest pace in 7 years. We have seen significant increases in the stock market. The Dow Jones Industrial Average was up 40 percent since March of last year. And the reports we have seen just this week confirm that strong economic activity and its continuation into this year, including personal income and consumer spending, continued their high rise; construction spending reached a record in December; manufacturing activity continued at a strong pace in January, following a 20-year high in December; and just today we heard that the service sector activity hit a record high in January and that manufacturers' orders and shipments increased again in December and by more than had been expected.

Additionally, the most important, and what I feel is most important, the economic is once again beginning to create jobs. For the past 17 straight weeks, unemployment insurance claims have remained below the benchmark regarded by economists as a sign of an improving labor market.

So today we are going to discuss not only the current state of the economy, but also what factors contributed to the better than expected growth we have seen over the past months. Certainly, as part of that discussion, we will take a look at the impact of the tax relief packages that we passed in 2001, 2002, and again in 2003, and how the tax relief helped to ease the recession and cushion us through the difficulties following September 11 of 2001 and, for that matter, the uncertainties of war in Afghanistan and Iraq. We will also discuss what role the tax relief will continue to play as we now build a foundation for sustained economic growth and job creation.

There is one thing that I would like to pin you down for now, and that is we need to do whatever we can to continue to get the economy growing and creating jobs. All of that great economic information that I was able to read for you is fantastic if you are a fully employed Treasury Secretary and Congressman or economist. If you are sitting around your kitchen table tonight, trying to figure out how to balance your checkbook and pay your heat bills and your college tuition, and you still haven't been able to find a job, all of that great economic data means absolutely nothing. And so we are going to continue to work to do whatever we can to make sure that the family budget comes first and that we can make sure that the economic relief that seems to be going well for the country at a macro level helps people around their kitchen tables.

The President has proposed making permanent the tax relief, and I can guarantee you that in this budget that will be one of the top priorities as we look to formulate our budget. We want to keep the economic growth moving. We want to be able to ensure that taxpayers don't get an increased tax bill; we don't think that increasing taxes at this time is a way to solve the very difficult situa-

tion we find ourselves in with budget deficits. We believe the budget deficit is an important job that we are called upon to provide answers for, but we also know that the security deficit that we faced over the last number of years, and the economic growth deficit that we faced over the last few years is still the most important thing that we can do to get the economy moving again, to keep our country strong and free, and get confidence not only to our investors here in this country, but around the world.

That said, I look forward to hearing your testimony, and I would now turn it over to Mr. Spratt for any opening comments he would like to make.

Mr. SPRATT. Mr. Secretary, welcome back. We are glad to have you. Mr. Secretary, you weren't here when the Bush administration first took office, but the budget was in surplus then, as you know; it was in big time surplus, surplus by \$127 billion that year, \$236 billion the year before, and your economists at Treasury and OMB looked out over the next 10 years and saw a cumulative surplus of \$5.6 trillion. Given these surpluses, both parties in Congress embraced a fiscal concept with a corny name called the "lockbox."

Despite that name, it was a substantive, serious idea, namely that we would use the surpluses in the Social Security and Medicare Trust Funds not to fund new spending, but to buy up outstanding Treasury debt. And in 2001, the first year of the Bush administration, it appeared that if we stuck to this plan, we could buy up most of the outstanding Treasury debt held by the public over the next 10 years and radically reduce the interest we pay on the national debt, add \$3 trillion to net national saving, and when the baby boomers began to retire and came to your window at the Treasury to draw down their benefits in Social Security and Medicare, Treasury would be more solvent than ever to meet those obligations. We had a golden opportunity.

Both parties in Congress at least professed that they were committed to this concept, but the Bush administration chose a different course. And, as a consequence, the Government is not paying down its debt. From 2002–04, the Government will add \$1.54 trillion, so much I can barely get it out of my mouth, to the national debt held by the public. And if the 5 year budget you now propose is adopted and carried out, the Government will stack \$1.35 trillion on top of that over the next 5 years. Three years ago, three short years ago we were positioned to buy back almost all of the outstanding Treasury debt held by the public by the year 2009. Now we are looking at adding \$2.5 trillion in debt by the year 2009, and billions more in the years beyond.

There is a series of charts that I am going to ask you to explain when we come to questions. They appear on pages 189–196 of the Analytical Perspective. The first of these I was going to show on the screen here, but I will show it to you later. These charts depict a grim fiscal future; they show that after the year 2009, the stopping point for your forecast, after that, the last year in your forecast, the deficit in the budget doesn't get better. There is the chart. The deficit in the budget doesn't get better, it gets worse and worse. These charts test six different variables. This particular chart tests a health care cost variable, another makes certain assumptions about productivity, another makes certain assumptions

about immigration. In none of these charts does the budget ever come to balance; indeed, it gets worse and worse and worse after 2009.

Now, the Bush administration tells us that this budget is going to cut the deficit by half over the next 5 years. Mr. Secretary, you can put me down as doubtful on that claim, because I have looked through this budget well enough to know not just what is in it, but what is left out of it. On the spending side there is nothing, not a dime for our deployments in Iraq and Afghanistan, though we were told yesterday the costs could easily be \$50 billion. On the revenue side, there is no reduction in revenues for what it will cost to fix the alternative minimum tax, even though the Treasury Department, your department, warns us that the number of taxpayers paying this higher tax will increase from 3 million this year to 36 million in the year 2012, and most of these are middle income taxpayers. The AMT for them is a tax increase.

The right fix to AMT could cut revenues by more than \$500 billion easily. I think you will agree. You asked for an additional \$1.2 trillion in tax cuts, but never mentioned the inevitable, and that is the cost of fixing the alternative minimum tax, which could easily raise the revenue request, the tax revenue cut to almost \$2 trillion.

By leaving out big items like this, this budget is able to show a deficit reduced in half by 5 years. But it stops short in 2009 and leaves the public to believe, I would think, that this budget will sort of correct itself, eventually balance in the years after 2009. Unfortunately, most Americans won't be reading pages 189–197 of the Analytical Perspectives on the Federal Budget, and they won't see that when your budget for 2005 is extended, as it is in this graph here, that is the middle green line, when this budget for 2005 is extended beyond 2010 over 10, 20, 30 years, the deficit gets worse and worse and worse. There is no solution in sight.

The Bush administration based its tax cuts on a blue sky forecast. We heard yesterday from OMB, and OMB now tells us that the \$5.6 trillion projected surplus was an economist construct which is never going to come about. In fact, they are reducing it by 53 percent per economic miscalculation, which is to say the surplus was really 2.6 trillion at best, rather than 5.6 trillion. The problem is the forecast has changed drastically, but the administration's tax agenda has not adjusted accordingly. The administration pictures itself and this budget as a victim of events beyond our control: terrorism, war, corporate scandals, the collapse of the stock market. And all these events have taken their toll, I wouldn't deny that, but from here out we are all on notice there are no more surpluses. Tax cuts and spending increases, particularly the tax cuts you are now proposing, \$1.2 trillion in additional tax cuts, goes straight to the bottom line and add dollar to dollar for the deficit. The deficits going forward, therefore, result from a deliberate policy choice, and that is to borrow and spend; to prefer tax cuts over deficit reduction.

Mr. Secretary, you are the keeper of one of our most precious national assets, our currency and our credit, and the big question we have for you today is how long can we sustain deficits of this size

without consequences to our currency, our credit, and our economy. We look forward to your testimony.

Chairman NUSSLE. I ask unanimous consent that all members be allowed to put a statement in the record at this point. Without objection, so ordered.

[Prepared statement of Mrs. Capps follows:]

STATEMENT OF THE HON. LOIS CAPPS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Thank you, Mr. Chairman. I said yesterday that the President's budget represents skewed priorities and this is clearly illustrated in his tax proposals.

For example, the President has called for making permanent virtually all of the tax cuts from the last 3 years. The budget notes that these changes will cost nearly \$1 trillion over 10 years. But since most of this cost occurs after the 5 years actually covered in the budget, the dramatically negative effect of this irresponsible proposal on the budget deficit is glossed over by the administration.

In addition, the benefits of extending the cuts go disproportionately to the wealthiest in our society even as the President underfunds education, veteran's care and environmental protection that are so important to tens of millions of American families.

Yesterday the administration witness, OMB Director Bolten, and many of my Republican colleagues constantly pointed to three tax provisions in particular—the child tax credit, the 10 percent individual rate and elimination of the marriage penalty—as evidence that extension of the tax cuts would benefit middle class families.

But those three provisions account for only 14 percent of the nearly \$1 trillion cost of making the tax cuts permanent. In addition, those benefits aren't just going to middle income families.

In reality, the vast majority of the \$1 trillion in tax relief goes to higher income taxpayers: income tax reductions for higher income taxpayers (\$395 billion), elimination of the estate tax (\$180 billion) and cuts in capital gains and dividend taxes (\$131 billion).

Similarly, the administration's proposals for new savings accounts will drain money from the Treasury to let the well-off avoid paying taxes on portions of their income under the guise of helping middle class families save for retirement.

Middle-class families can already put up to \$3,000 in various IRAs each year and many workers have 401k's at work. But only 4 percent of families actually fully fund their IRA's each year, most likely because they can't afford to save more.

The President proposes to create two new accounts, raise the current limits and loosen the restrictions for withdrawals. This will likely effectively allow higher income taxpayers to shelter more of their income from taxes without encouraging any real new savings.

Finally, the President's proposals for helping the more than 43 million Americans without health insurance get coverage are expensive and will not work. The \$70 billion in tax credits for purchasing health insurance are supposed to be paid for with offsets the administration can't or won't identify so one has to wonder how serious the administration is about the proposal.

In addition, according to OMB's own mid-session review from last summer the tax credits have not been shown to be especially effective and can be expected to be used by younger, healthier people currently insured. If so, this proposal benefits people who already have insurance, not the uninsured.

The Health Savings Accounts proposal will likely encourage younger, healthier people to drop out of the insurance pool thereby increasing rates for older, less healthy persons left behind. Similarly, HSAs may encourage employers to drop coverage. And HSAs will likely offer little help to the uninsured since the vast majority of the uninsured are low income persons who really won't benefit from the deduction and other HSA tax benefits.

The common theme running through these proposals echo that of the overall budget. The impacts of these proposals on the budget are dramatically understated, the proposals will primarily benefit wealthier Americans, and adoption of them leaves little funding to address critical national needs that benefit middle class families.

We should reject these ill-thought out tax proposals and return some sanity to this budget process.

Chairman NUSSLE. Secretary Snow, we welcome you back to the committee. We are pleased to put your entire testimony into the record, and you may summarize as you wish. Welcome back.

**STATEMENT OF HON. JOHN W. SNOW, SECRETARY,  
DEPARTMENT OF THE TREASURY**

Secretary SNOW. Mr. Chairman, thank you very much.

Congressman Spratt, thank you for your opening comments as well. It is a great pleasure to be back here with you.

As the chairman said, when I appeared a year ago, the American economy was on a far different course. Thanks to your actions in the Congress in adopting the President's Jobs and Growth Bill, we are now on a good course, we are on a strong course. I don't need to recite the numbers, the chairman did. There can't be any doubt about the fact that the American economy is in a fundamentally better position today, poised for long-term sustainable growth; whereas, a year ago, you will recall, the concern was of a double-dip recession; the concern was of deflation, it was all in the year, deflation; the recovery was described as anemic or wobbly. Today it is a strong recovery: 8.2 percent growth rates in the third quarter; 4 percent growth rates in the fourth quarter; 4.4 for the year, which is a recovery year; with the outlook for 4 percent plus for the coming year. With 4 percent growth, we get jobs coming back.

The labor markets have begun to firm up, and we are confident we will see a considerable number of jobs added to the workforce of America. We have seen the unemployment rate march down from 6.3 to 5.7, we have seen the initial claims for unemployment insurance march down over the course of the last 6 months, we have seen the stock market rise 26 percent or so, reflecting, reflecting the expectations of a stronger economy directly related, directly related to the actions of this Congress in passing thoughtful and far-reaching and visionary tax legislation that makes the American economy fundamentally more efficient. When you make something more efficient, you get good results, and those results have been reflected and captured in the sizeable increase in the equity values of America, which have restored people's IRAs and 401(k)s, which had been so badly, badly depleted. I think we are on a good course, and I want to commend all of you for your actions and leadership in putting us on that course.

Now the fundamental question is how do we sustain the growth we have, and, as the chairman has suggested, I think the worst thing you could do is have a tax increase. A tax increase would roll it back, it would take us right back down the path we have come up. We don't want to go there; that would be a mistake. Can we afford the tax reductions? Of course we can. Of course we can. What we can't do is afford not to keep them, because if we don't keep them, then we don't grow the economy, and we put a tax increase on literally every single American; millions and millions of small businesses, millions and millions of middle income people who are making economic decisions today, spending money today in the expectation that they will have those tax reductions going forward. So I would argue as strongly as I can that we need to keep those tax reductions in place. We need to make it clear to the American people that those tax reductions will be sustained.

Now, moving to Congressman Spratt's comments, he rightly points out, I think we would all agree, that deficits matter. Of course deficits matter. Deficits matter because, unless they are addressed, the financial markets will respond in ways that are negative: they will raise real interest rates. But they will do that only if they think we aren't going to act responsibly and we are going to act responsibly. Deficits are troublesome when they are large and growing and ingrained and entrenched. These deficits aren't that. These deficits will be declining, falling to a level which is lower than the historic average of deficits as a percent of GDP, to under 2 percent. The best single evidence, the best single evidence that the stock markets credit us, all of us, with the ability to manage the fisc of the United States well is the fact that today we have the lowest interest rates in 45 years. If the financial markets doubted our ability to manage our way through the deficit, they would begin immediately, Congressman, to exact a price, and that price would be higher real interest rates. The fact that we have 40-year low interest rates is compelling evidence that the markets trust our ability to work through these deficits, to hit the targets the President set of cutting those deficits in half over the course of the next 5 years.

I very much look forward to working with all of you to see those proposals put in effect, but we will do it also in the proposals in the President's budget to improve savings in this country, and I have talked with a number of you about it, importantly, Congressman Portman; to continue to move forward to find ways to make health care more affordable, and that is incorporated in a number of ways in the budget; to help to ensure that pensions are properly funded and, of course, that is part of the administration's proposal.

So I very much appreciate—Mr. Chairman—the chance to be up here today with you and to respond to your questions, and to work with you in seeing that we sustain the growth path that the American economy is on and the path to cutting this deficit in half over the course of the next 5 years. I thank you very much.

[The prepared statement of Mr. Snow follows:]

PREPARED STATEMENT OF THE HON. JOHN W. SNOW, SECRETARY, DEPARTMENT OF  
THE TREASURY

Thank you, Mr. Chairman. Thank you all for having me here today to talk about the President's budget.

I believe you'll find that this budget reflects the priorities of our Nation as well as the leadership of President George W. Bush. The over-riding theme of the budget, and the President's plan for the future, is that a safer world is a more prosperous world. That's why I'll be discussing both national and economic security here today.

OVERVIEW OF THE PRESIDENT'S PRIORITIES

Decisions about how to collect and spend taxpayer dollars—for this is what a budget is—must be made with both caution and vision.

The fiscal year 2005 budget proposal is, therefore, a plan that does three core things:

- One: Keeps Americans safe by providing the resources necessary to win the war on terror and protect our homeland;
- Two: Increases the economic security of our citizens as well, by strengthening our economy; and
- Three: Exercises the kind of spending discipline that is required by a government that respects the source of its money (hard-working taxpayers!) and is unwilling to live with a deficit. Discussions of our budget and our economy are not, and should not, be separate.

The two are inextricably connected.

Today, our economy is doing better. Homeownership is up, unemployment rates are heading down, and GDP growth has been extremely strong. This administration came to office when those indicators were not nearly as positive. The President inherited an economy that was in decline—one that was then battered by terrorist attacks and revelations of corporate corruption dating back to the 1990s.

The President and his administration took these challenges seriously and we have made serious progress in changing the economic direction of this country. The President's tax cuts—passed by you—have worked. They provided the stimulus that was necessary to turn the economic ship around and they are now encouraging and allowing for the economic growth that is continuing into the future.

- Economic growth in the second half of 2003 was the fastest since 1984;
- New home construction was the highest in almost 20 years;
- Homeownership levels are at historic highs;
- Manufacturing activity is increasing;
- Inflation and interest rates are low;
- Over a quarter million jobs were created in the last 5 months of 2003.
- Unemployment claims—both initial claims and continuing claims—are falling, indicating improvement in the labor market;
- And last Monday, the Dow closed at a 31-month-high. This translates into more than three trillion dollars of growth in value in the markets.

These economic indicators all point to the same conclusion: We are on a path to sustained economic growth.

However, there is more to do. We are not, by any means, satisfied. There are still Americans who want to find work and cannot, and this administration will not rest until that most critical need is met and until every American looking for work can find a job. Our budget addresses that need by continuing to focus on improving our economy.

For example, the President's Jobs for the 21st Century plan, announced in his State of the Union Address, directs the resources of several branches of government toward matching skills with jobs, and helping workers acquire the skills they need to qualify for the jobs in their community.

We can also encourage the creation of jobs by sticking to the President's six-point plan for growth.

That includes making health care more affordable and costs more predictable. We can do this by passing Association Health Plan legislation that would allow small businesses to pool together to purchase health coverage for workers at lower rates. We also need to promote and expand the advantages of using health savings accounts—how they can give workers more control over their health insurance and costs. And we've got to reduce frivolous and excessive lawsuits against doctors and hospitals. Baseless lawsuits, driven by lottery-minded attorneys, drive up health insurance costs for workers and businesses.

The need to reduce the lawsuit burden on our economy stretches beyond the area of health care. That's why President Bush has proposed, and the House has approved, measures that would allow more class action and mass tort lawsuits to be moved into Federal court—so that trial lawyers will have a harder time shopping for a favorable court.

These steps are the second key part of the President's pro-jobs, pro-growth plan.

Ensuring an affordable, reliable energy supply is a third part. We must enact comprehensive national energy legislation to upgrade the Nation's electrical grid, promote energy efficiency, increase domestic energy production, and provide enhanced conservation efforts, all while protecting the environment.

Again, we need Congressional action: we ask that you pass legislation based on the President's energy plan. Streamlining regulations and reporting requirements are another critical reform element that benefit small businesses, who represent the majority of new job creation: three out of every four net new jobs come from the small-business sector! Let's give them a break wherever we can so they're free to do what they do best: create those jobs.

Opening new markets for American products is another necessary step toward job creation. That's why President Bush recently signed into law new free trade agreements with Chile and Singapore that will enable U.S. companies to compete on a level playing field in these markets for the first time—and he will continue to work to open new markets for American products and services.

Finally, we've got to enable families and businesses to plan for the future with confidence. That means making the President's tax relief permanent. Rate reductions, the increase in the child tax credit and the new incentives for small-business investment—these will all expire in a few years. The accelerated rate reductions

that took effect in 2003 will expire at the end of this year. Expiration dates are not acceptable—we want permanent relief.

The ability of American families and businesses to make financial decisions with confidence determines the future of our economy. And without permanent relief, incentives upon which they can count, we risk losing the momentum of the recovery and growth that we have experienced in recent months.

The tax relief is the key stimulus for increased capital formation, entrepreneurship and investment that cause true economic growth.

Budgets work better when the economy is growing—because a growing economy means more jobs. That means more tax revenue—which leads to all-important deficit reduction.

Which leads me to my next area of discussion.

#### OVERVIEW OF THE BUDGET DEFICIT SITUATION

Let me be clear on this:

- The budget deficit that we face today is unwelcome.
- It needs to be addressed.
- The President's budget calls for cutting the deficit in half over the next 5 years.
- While addressing the deficit, we must remember that it is not historically overwhelming.
- It is understandable, given the extraordinary circumstances of recent history. Remember that we are fighting a type of war that we have never fought before. We are fighting an enemy that requires a much broader variety of government resources than anything we've ever confronted. And we began this fight when we were economically wounded.

What's most important to remember is that we will be able to fight this war and climb out of the deficit. We can manage this deficit, and we can cut it in half over the next 5 years by controlling spending and growing our economy. Three-quarters of the discretionary spending increases during this administration have been related to the global war on terror and the response to 9/11.

Meanwhile, President Bush has reduced the rate of increase in non-security-related spending every year he has been in office: to 6 percent in 2002, 5 percent in 2003, and to 4 percent in the current fiscal year. For fiscal year 2005 we're going to reduce the rate of increase in non-security spending to less than 1 percent. Total annual appropriated spending will increase by less than 4 percent next year.

Holding the line on spending—while ensuring that our country is safe and our most important needs, from jobs to health care, are met—will achieve deficit reduction when coupled with all-important economic growth.

Again, this is why the budget cannot be discussed separately from the economy. Separating the two is what gets government into trouble.

Make no mistake; President Bush is serious about the deficit. We see it as unwelcome, but manageable—and we intend to achieve: rapid deficit reduction.

A recent CBO report raised concerns about this matter, and it is important to note that recent and short-term projected budget deficits and the existence of long-term deficits for Social Security and Medicare are not connected.

These unfunded long-term net obligations are also a concern, and ones that this administration has highlighted and invited bipartisan dialogue on.

The President has been clear on this: younger workers should have the opportunity to build a nest egg by saving part of their Social Security taxes in personal retirement accounts. His vision for the program is economically wise, and it is that we should make the Social Security system a source of ownership for the American people.

#### CONCLUSION

Are we dedicating ourselves to increased spending on the war on terror and protecting the homeland? The answer is yes. Yes, without sacrificing other necessities. And that is because a nation must be safe in order for it to be prosperous. A nation of entrepreneurs must also be able to plan, and to be relieved of as many burdens as possible, in order to be prosperous.

All of the budget issues and policy proposals that I've discussed today may seem, at times, to be a complicated recipe. But these ingredients combine to make something that is simply put, and is of utmost importance—and that is economic growth. Growth is the key to every economic problem we confront. That's why we urge other countries to institute pro-growth policies. It's good for them, and it's good for the global economy that we are a significant part of.

Thank you for hearing my testimony today. I'll be happy to take your questions now.

Chairman NUSSLE. Thank you, Mr. Secretary. Mr. Secretary, you used to, prior to being in this job, you used to, as I did and many of my colleagues on both sides of the aisle have done, preached about the benefits of balanced budgets. Remind us about the benefits of a balanced budget. What is so good about having a balanced budget?

Secretary SNOW. The virtue of fiscal restraint, the virtue of having deficits manageable is, of course, that it secures the confidence of the financial markets; and the confidence of the financial markets is important because if financial markets don't have confidence, they exact a price. That price is higher real interest rates. We have seen this in countries that don't have sound fiscal policy. We have seen many Latin American countries pay extraordinarily high interest rates, reflecting, the financial markets' lack of confidence in those countries. High real interest rates have bad consequences. High real interest rates choke off growth and contain the future growth path of a country to a lower level. We don't want to get on that path, and we won't, we won't if we follow the guidance of this budget.

Chairman NUSSLE. On January 1, 2001, we had a balanced budget. On September 8, 2001, we had a balanced budget. September 9, we had a balanced budget. Even September 10, we had a balanced budget. We had a surplus. How come we weren't in nirvana? What was wrong? I mean, was that surplus protecting the country? Was it creating jobs? Was it strengthening our economy? Why, if we had a surplus and had a balanced budget, did we find out just a day later that it wasn't enough to protect the country, that it wasn't enough to create jobs and keep our economy strong? What was wrong at that moment in time that a balanced budget was not enough to, in a compelling way, provide us with security for?

Secretary SNOW. Your question suggests its own answer: tax rates were too high. We were heading into a recession at the dates that you have cited, a recession that the President, unfortunately, inherited.

Chairman NUSSLE. But we had a balanced budget. How did we get into a recession if we had a balanced budget? You mean balanced budgets don't prevent us from going into recession?

Secretary SNOW. No. No, not by any means. They are not a panacea, Mr. Chairman. Everything else the same, smaller deficits are advantageous, but they are not, in and of themselves, economic nirvana. That is your point, I think. They are not economic nirvana. An awful lot else has to be right. An awful lot else has to be right, including appropriate tax policies, appropriate trade policies, a sense of security on the part of the citizens so that they have confidence in their institutions. An awful lot has to be right for an economy to work well.

In the period you cited, we had a balanced budget, but we had a lot of other things that weren't going right. We just had a meltdown in the stock market. It was to get worse. We had just seen the collapse of manufacturing output that started in the summer of 2000. We were beginning to see the effects of corporate scandals, mistrust of people in the corporate suites and in the boardrooms. Those things took their toll and the economy, of course, went into a tailspin; and that tailspin would have been a lot worse, in my

view, if the Congress, in 2001, had not taken the actions you took to lower tax rates, and the actions in 2002 to encourage investment spending, and, most importantly, the actions in 2003 to do the things you did there with capital gains and dividends and lowering marginal tax rates across the board, expending for small business, and so on. That was far-reaching tax legislation without which the economy, in my view, would be far poorer today, would not be on the strong growth path that it is on, and we would have as many as a couple million additional people unemployed and growth rates of 2 percent or so less than we have today.

Chairman NUSSLE. Well, I hear a lot of discussion about the fact that our President inherited a surplus, and how that must have been able to do so much, and yet it appears to have done very little, because I believe while the books of the Government may have been in balance, this President inherited a security deficit, an economic deficit, certainly an economic growth deficit, a job-creating deficit, a wasteful Government spending deficit. This surplus wasn't preventing us from wasting money in Washington, it wasn't preventing us from doing a lot of things, but it sure made a lot of people feel good that worked in the fancy white buildings in Washington, DC. But it doesn't appear it was helping many people back home that were working in the factories and the farms and the villages that I represent and so many of my colleagues represent. And what I see us doing now is trying to repair some of those deficits. Yes, it means the books of the Government are going to be unbalanced for a period of time, and we are about the job of making sure that they get back in balance and that we do reduce that deficit.

But I want you, if you would, just to finish, because my time has expired, if you would finish on the topic of confidence, because, again, you spoke to this earlier, but I want you to compare the two periods of time: pre-9/11 confidence and post-9/11 confidence. It would seem to me, or at least it may appear to some, as though our investors from around our country and world may have had a lack of confidence based on purely the deficit figures. But is there more to confidence than merely whether or not the books are balanced in the Government? Would you speak to both sides of the ledger, please?

Secretary SNOW. Yes. Yes, sir, Mr. Chairman, I would be pleased to and maybe a little anecdote will help begin my answer. I was in Charleston, WV last week meeting with people who were engaged in the housing business, and happened to go to a community that was of new homes. And the investor and construction person who was leading this effort to build these new homes took me to the site of a new house, and he is taking me through this and he pointed to another house and he said, on September 12, 2001, I stood at that house over there, a block away, and he pointed to it, and he said, I thought to myself what have I got myself into? I am way in hock for this development project; we have just had the terrorist attacks on America. Will America lose its way? Will America sustain its confidence in itself so that people like me, who are investing capital, and others will see their projects be able to go forward, or will America unravel? Those were his words, will America unravel. He said thanks to the leadership, and Congress certainly played an important role in that leadership, and most of all the

President, I would say, he said, thanks to that leadership, the country didn't unravel. The country sustained its confidence in itself and its institutions and its ability to move forward.

That confidence in the leadership of the country, in the institutions in the country, the resiliency of the country I think is critically important, and on that score we are far stronger today. We are far stronger. We have demonstrated our ability to weather extraordinary shocks and to put them behind us; the shocks of the corporate scandals, the shocks of 9/11, homeland security, the war in Iraq, the war in Afghanistan, so on. We have sustained enormous shocks and we have come out of it stronger and better.

I agree with you fully that balancing the budget is desirable, but in and of itself it is not enough to sustain the institutions of the country or the economy of the country. I associate myself with your comments on that subject.

Chairman NUSSLE. Thank you, Mr. Secretary.

Mr. Spratt.

Mr. SPRATT. Mr. Secretary, let me show you again the chart I referred to in my opening statement, which comes from the Analytical Perspectives on the Federal budget. And this particular chart, which we simply copied electronically, shows an extension of the 2005 budget, the one now before us, out over the next 30, 40, 50 years. And what it shows is that slightly after the terminal year in your budget presentation, which is 2009, around 2012 the budget begins to worsen. This is your 2005 budget extended, it is not hypothesized. And, as a consequence, the deficit does all the things that you said are iniquitous about deficits, namely, they are permanent, persistent, and increasing as a percentage of GDP. Is this a correct depiction of what we are looking at in our near future? It is not far off; 2010, 2012 is not far away; easy enough for markets to perceive and anticipate and begin to respond to.

Secretary SNOW. Congressman, I think what you are referring to, if I have it right, is the projections on Medicare costs, health care costs.

Mr. SPRATT. Well, there are six variables that are tested in these presentations here. One is health care cost, one is immigration, one is productivity. There are six different variables. One of the variables not tested is revenues but, nevertheless, there are six different variables. I only copied one, and in every case the deficit gets worse and worse and worse; it doesn't get better. And that green line right there in the middle, or whatever color it is, is the 2005 budget. And you get a little higher growth or lower growth depending on what the health care cost assumptions are, but they don't correct the problem.

Secretary SNOW. The problem depicted in this chart has virtually nothing to do with the budget proposals that we have put in front of you or with making the tax cuts permanent, virtually nothing.

Mr. SPRATT. Why is it in the budget, then? Why was it put in there?

Secretary SNOW. Well, because it is honest budgeting; it is telling you where Medicare and Social Security are headed.

Mr. SPRATT. This is the 2005 budget and there are some variations on the health care costs assumptions in it, showing you the band of variability.

Secretary SNOW. But what it is depicting is something that we are all aware of: that with the retirements of the baby boomers here in the years ahead, and we are coming up on the first wave of the baby boomers, demographics are destiny. What you are seeing here is the effect simply of demographics playing out as we move from the 3 workers for every retiree to 2.9, 2.8, 2.7, 2.6, 2.5. That is the trend we are, and that trend produces these numbers, and it is why we need to get control of health care costs, because what is driving this is demographics and rising health care costs.

Mr. SPRATT. Well, what is driving this is demographics, I agree with that, but the baby boomers are already born; there are 77 million of them marching to their retirement as we talk right now. It is a fiscal inevitability that we will have to confront by 2008, and it gets worse each year. So my question to you is this is a depiction of the budget. One would think, from reading your budget, that after 2009 it kind of self-corrected, it would eventually balance itself. This chart, replicated six times with different variables, shows that it gets worse and worse and worse; it is persistent, and as a percentage of GDP and an absolute amount, it gets worse every year shortly after the terminal year in your budget, which causes one to suspect is that why the budget wasn't run out 10 years in the first place.

Secretary SNOW. Can I suggest to you, Congressman, something I think you know? And that is if you took the tax reductions out of the numbers depicted in this graph, the graph wouldn't look much different.

Mr. SPRATT. I am just asking you this is the course of the budget after 2009. It doesn't self-correct, it doesn't get better, and, therefore, instead of looking out over the promised land, we are looking into a chasm in 2009, 2010.

Secretary SNOW. I serve on the Medicare and Social Security trusts, as the trustee of both of those trusts. These numbers are the numbers we see as trustees of Social Security and Medicare, and unless something is done about the unfunded status of those two major programs, we are going to see numbers like this, which means we can't let those numbers evolve; we have to be taking the steps soon to deal with the problem so that these numbers don't come to pass. That is why the President has proposed the reforms on Social Security; it is why we have proposed a number of measures on health care.

Mr. SPRATT. Mr. Secretary, if the President's proposal on Social Security, which has not come to us fully formed, but if it were, let us say, a 2 percentage points diversion of FICA into private accounts, that would create a diversion of \$100 billion dollars of revenues away from the general fund into private funds; you would have to back that out of your revenue estimates. You would never balance the budget over the next 5 years. So the Social Security proposal is mutually exclusive with the claim that you can get the budget deficit cut by half in 5 years.

Secretary SNOW. The Social Security problem, Congressman Spratt, as you know as well as I, is going to have to be dealt with, and it will cost something to deal with it.

Mr. SPRATT. Cost in benefits, you mean, benefit reduction?

Secretary SNOW. Well, it will cost something. It will cost something. Putting in place the personal accounts would require some borrowing; it would require some transition costs.

Mr. SPRATT. Well, it would enlarge the deficit, would it not? You are diverting revenues out of the general fund into private funds.

Secretary SNOW. Any fix for Social Security, any fix for Medicare will inevitably involve some give somewhere in something.

Mr. SPRATT. Let me switch to a couple of things and then turn these questions over to others. The alternative minimum tax, also in the Analytical Perspectives pages 76 and 77, which Treasury probably wrote, you said if we don't do something to fix this, not just amend it, but permanently revise and fix it, that by 2012 36 million taxpayers will be paying this higher rate, and most of them will be middle income taxpayers for whom the tax alternative minimum tax was never intended. We have seen estimates that the cost of fixing this would range from \$500 to \$600 billion.

Now, you are warning us that it is coming, that it has to be handled, but you didn't put it in your agenda, and whenever we see the tax cut agenda from the Bush administration, for some reason this gets omitted from it, even though you are saying here it is inevitable, unavoidable. Indeed, if we pass the additional tax cuts and make them permanent, then we add to the deductions and credits to preference items that make the AMT applicable to more and more taxpayers. Why are you not proposing in your tax proposals, which are \$1.2 trillion in additional tax relief, some fix to the AMT?

Secretary SNOW. Because we don't have the fix in mind yet. We did indicate, though, in the budget that we would be working hard to be in a position a year from now, when we are up before you, to talk about a fix. The fix is going to be complicated, though, because the alternative minimum tax so intimately affects the regular tax and is so interlaced with the regular tax. This is an incredibly complicated thing, complex thing to deal with.

Mr. SPRATT. Wouldn't you agree that if it isn't fixed, it amounts to a tax increase for 36 million Americans?

Secretary SNOW. Well, of course, it is in the baseline now, so I guess under current law it wouldn't be a tax increase. I will grant you, though, that a lot of people that don't anticipate paying the tax will find themselves paying a tax if we don't fix it, yes.

Mr. SPRATT. And the cost would be five to \$600 billion, would it not? Substantial.

Secretary SNOW. It could be. The alternative minimum tax is scheduled to generate very sizeable revenues in the years ahead.

Mr. SPRATT. One final question. One of the unpleasant consequences of running substantial deficits is that, from time to time, we have to raise the debt ceiling. The debt ceiling is now \$7.384 trillion. It was recently raised on May 27, by \$984 billion, the biggest increase in history. When do you expect us to raise it again, and when will you present that request to the Congress?

Secretary SNOW. Well, as we look at the numbers now, Congressman, it looks like sometime late summer that we would need to raise the debt ceiling.

Mr. SPRATT. By how much?

Secretary SNOW. Well, that depends on how far out you want to avoid facing that issue again, because one thing we know in life, death, taxes, and the debt ceiling confront us.

Mr. SPRATT. Well, it would be at least six, \$700 billion, would it not, because you are running deficits close to \$400 billion?

Secretary SNOW. Congressman, it just depends how far out the Congress wants to confront the issue again, really.

Mr. SPRATT. Thank you very much, Mr. Secretary.

Chairman NUSSLE. Mr. Hastings.

Mr. HASTINGS. Thank you, Mr. Chairman.

And thank you, Mr. Secretary, for appearing before us today. I was struck, and I don't know, in deference to the distinguished ranking member, what all made up that chart, but one thing did strike me in looking at that chart, where you are estimating some sort of action 20 or 30 years in advance. And we all know, and that is the frustration I have certainly experienced in my time in office, is trying to make decisions based on the expectations in the future; they change a lot. And I recall my first term in office, just to give an example of that. We were confronted in this Congress with the board of trustees of Medicare saying that unless we acted by 2002, Medicare would be dead broke. And so that was the best information that we had. We attempted to change that, it got caught up in politics in the 1996 election. We came back in 1997, I recall, and the trustees came back and said we have got bad news: it is no longer 2002, it is 2001. So we made those changes.

Now, I suspect that if that chart showed Medicare expenditures in the future based on 1995, it would probably have been a lot worse, but the actions of future Congresses change the course of those things. I think that the President and the administration taking on, looking at Social Security, the sacred cow that I recall going on for many, many years, nobody would ever touch it, is entirely the right thing to do, because future Congresses will confront that. So I just wanted to say that, recognizing that trying to estimate revenues and expenditures in the future, without taking in the dynamics what future Congresses could do, sometimes is an exercise that is pretty hard to confront directly.

But what I would want to ask you, though, is because when you were here last year, things looked pretty bleak; they look a whole lot better. In those projections that you are looking at, is there anything that you can see from your responsibility in all this could be characterized as a rosy scenario as to the economy, the effect of tax relief that we give to the producers in this country, and so forth?

Secretary SNOW. I think our budget is quite conservative with respect to the economic assumptions; more conservative, for instance, than CBO in many respects, and more conservative in many ways than the blue chips. So there may be some upside sensitivity here. But this is conservative and I hope we could do better than this in terms of the revenue side and the receipt side.

Mr. HASTINGS. Well, I think that sometimes when we get inside the Beltway here, we tend not to trust the people in our respective districts to make their own economic decisions for themselves. I certainly hear that when I go home, and so I think we are on the right course. Sometimes the hard part is to stay on that. And I con-

gratulate you for your enthusiasm as to where we have come in the past. So I thank you very much for your presence being here.

Chairman NUSSLE. Mr. Moran.

Mr. MORAN. Thank you, Mr. Chairman. Mr. Chairman, I have been reading this book about Treasury Secretary Snow's predecessor, and I would recommend it to you as well, in fact, all the members of the panel.

I was particularly struck by a passage that is on page 291, if you want to review it at some later point, Mr. Treasury Secretary. It talks about Vice President Cheney arguing with regard to the elimination of taxes on dividends, saying that it would provide positive stimulus. Treasury Secretary O'Neill jumped in, arguing sharply that the Government is moving toward a fiscal crisis, and then pointing out what rising deficits will mean to our economic and fiscal soundness. Dick cut him off, that is the Vice President. Mr. Cheney said, "Reagan proved deficits don't matter," he said. Treasury Secretary O'Neill shook his head, hardly believing that Cheney would say such a thing. He was speechless. Cheney moved to fill the void: "We won the midterms. This is our due." And then he left, contemplating the difference between philosophy and ideology, because this was brazen ideology. And his last quote in this paragraph is "Ideology is so much easier because you don't have to know anything or search for anything, you already know the answer to everything. It is not penetrable by facts, it is absolutism."

Now let me point out what is happening to the deficits. That dark blue line is President Bush No. 1—41 we will call him—Bush 41; and then that very positive light blue line is after President Clinton took over, balanced the budget and put some credibility into the idea of a balanced budget amendment, restricted spending, raised revenues sufficiently. And, in fact, you can see an extraordinary positive line and, of course, that took place simultaneous with the greatest economic boom that our Nation sustained, boom that our Nation has ever experienced. That very frightening red line at the end, that tail, is your watch basically, our President Bush 43's watch. You can see why many of us are very much troubled by what has happened with regard to deficits.

And let me point out why deficits do matter. I would like to get that chart on the debt tax, if we could. This is how much each family owes on the debt tax, which is something we will have no control over; the Congress has to pay off interest on the debt that we have already incurred. And if you look at this chart today, the American family owes about \$4,400; by 2014, in 10 years, they will owe more than \$10,000. But David Walker, the head of the General Accounting Office, just told us last week in a speech that, in fact, if we try to pay off that debt, to eliminate this debt tax of interest that families are having to pay, that would be \$96,000 per family, \$24,000 for every man, woman, and child in America. And if we try to reimburse the trust funds, the Social Security and Medicare Trust Funds, that are the only reason you can make the claim you are going to try to balance the budget, eliminate deficits over the next 5 years, because you are taking it all from Social Security to make up that gap, if you added that in, it is another \$100,000.

So we are talking about astronomical numbers that we have dumped on the backs of our children and grandchildren. That is

the most outrageous thing that any administration has done to the American public. And, of all people, when you were head of the business roundtable, I thought that you made a pretty compelling point that you understood how much deficits matter, and yet here it is your watch, and look at the debt tax that we are dumping on American families. And, of course, we have got this jobless recovery. That doesn't make it any better. I don't know where they are supposed to get the money to pay off this tax you are giving them. We have got a transportation bill that you are opposed to. Here you headed CSX; you know that for every billion dollars you invest in transportation infrastructure, it generates 42,000 new jobs. How wonderful that might have been last month, instead of seeing a net gain of 1,000 jobs, if we had actually seen jobs increase in the tens of thousands.

So we are troubled, and I would like for you to reassert your position on deficits. Do they matter? And, if so, what are you going to do about the debt tax, Mr. Secretary?

Secretary SNOW. Congressman, thank you.

Mr. MORAN. Nice to see you. I think you are a constituent, too.

Secretary SNOW. I am.

Chairman NUSSLE. The gentleman's time has expired, but if you would like to respond to your Congressman, you can do that.

Secretary SNOW. He is my Congressman and I will find a chance to have a more elaborate answer. But your first chart didn't show the red line turning post-2005, and it will turn, and it will turn sharply, and it will bring the deficit to a level which is a percentage GDP, and that is really the way to look at it, that is lower than the historic level for the United States. And, as I said, if the financial markets thought that we were not properly managing the fiscal policy of the United States, if they thought that we were derelict in our duties, if they thought we didn't have an approach to reduce the deficit, we wouldn't have, today, the lowest interest rates in 45 years. So I think the red line there is going to turn up nicely, and as it turns up nicely, the deficit will fall to levels that are quite low by historical standards.

Mr. MORAN. I hope you will excuse us for our skepticism, Mr. Secretary. We will believe it when we see it. Thank you.

Chairman NUSSLE. Mr. Putnam.

Mr. PUTNAM. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. I was observing the previous gentleman's line of questioning, and as somebody who, along with Harold Ford, is going to be around to pay the debt tax, I appreciate his concern about that, the deficit, although I am a little confused about the last concern about there not being enough spending, but I think that reflects the reality around here, that a lot of us have tried to have it both ways for a long time and now it is time to make some tough decisions.

You have commented about the effect of the low interest rates, and they have certainly softened this past recession; they have fueled an unprecedented housing boom, they have allowed people to extract equity from their homes and use that to continue to be consumers. What are your thoughts on maintaining those low interest rates, and what effect will an increase in those interest rates have on our continued economic expansion?

Secretary SNOW. There is no doubt about the fact that current low interest rates have been very helpful for this economy, and they have led to, as you know, a tremendous refinancing in the housing market. We now have home ownership in the United States approaching 70 percent, the highest level ever. New housing starts last year were, what, 1.85 million another record. The housing industry has done very well and has been a bulwark of strength for the economy, which the low interest rates and our good capital markets, housing finance markets, are part of the underlying strength of the country. Low interest rates also allow the monetary authority to be patient in changing direction, and that is helpful.

I think we have got, fundamentally, a low inflation economy, which justifies low interest rates. Part of that equation, of course, is very high productivity and trade that brings in low cost goods from other parts of the world. A combination of trade policy that allows low cost goods to come in, stretches consumers' income, high productivity, the overhang, I would say, of some of the consequences of the late 1990s, going back to the chairman's question to me, of continuing excess capacity. The late 1990s were a period when there was overinvestment in a number of industries. That excess capacity still is out there and is restraining prices. High productivity, of course, holds prices down, makes firms more competitive. I think we have a basic low inflation, low interest rate environment.

Mr. PUTNAM. Do you believe we will be able to sustain the types of productivity gains that we have seen over the last several quarters?

Secretary SNOW. At some point productivity gains will have to come down a little, I would think, because the law of diminishing return applies to everything. We have had such high productivity for so long; I think it is 4.4 percent for the last 3 years. It came in at an astonishing 9 percent in the third quarter, clearly not sustainable for the long-term. And this quarter we haven't got the number finalized yet, but it looks like it was around 3 percent, coming down from that average of 4.4. It would be natural to expect some reduction over time of these extraordinarily high productivity rates.

Mr. PUTNAM. So we have rung a great deal out of our productivity. The American worker, with the help of technology and education, is doing all they can do. The charts, I think, show that we can only grow our way out of the deficit to a certain degree. And, of course, we have to constrain spending, but we are talking about discretionary, which is a portion of the budget, and the non-defense, non-homeland, which is even almost a minute portion of the overall budget. So what type of a shock to the system will it take, then, to really be able to accelerate our deficit reduction measures?

Secretary SNOW. There are only two ways to deal with the deficit, I wish there were more but it really comes down to two. One is good growth and that generates government receipts, so you get that side of the equation working and growth is essential to do that. So growth is absolutely critical. It is a necessary condition to deal with the deficit but I think we have to acknowledge, and the budget does, that it is not a sufficient condition. Spending controls

are also required. The budget reflects that in the non-homeland, non-defense area and it reflects it in a way that is pretty tough minded on spending, less than 1 percent, half of 1 percent I think if I recall the number in terms of growth. So it is a tight budget but it is a budget that works in the sense that with the growth we see in the economy and the receipts that will come in. There is a lag there but will come in and with the tight spending, we do come back to cutting that deficit in half both in nominal terms and more than half as a percentage of GDP over the 5-year period.

Chairman NUSSLE. Thank you very much.

Ms. Baldwin.

Ms. BALDWIN. Thank you, Mr. Chairman.

I wanted to say something about the Treasury Department's use of averages in describing the benefits or more specifically, the distribution of benefits of tax relief. I raise this particularly because this budget extends certain tax cuts, makes permanent certain other tax cuts and proposes certain new tax cuts.

Last year, the Treasury Department issued a release that stated that "91 million taxpayers will receive on average a tax cut of \$1,126." We all know what averages are, I am not going to contest that statement. When you peel a little bit back, we have to recognize that we are talking to the American public about who benefits and how the benefits are distributed and who doesn't. So as we peel that away, we learned if you just look at middle income, the middle fifth of households, their average tax cut of that particular tax package was only \$217. We learned that 83 percent of households will get less than that average amount cited by the administration and your department. Some 53 percent of U.S. households, in fact, 74 million households would receive tax cuts of \$100 or less, including 50 million households that would receive none whatsoever.

If you just switch to statistics released by the Treasury Department on the small business owners and households with small business income tax cuts, they were told that 23 million would receive an average tax cut of about \$2,209 in 2003. I had a chance to speak with many small business owners in my district about their benefits under these proposals and I would never think of swearing in front of this committee or you, Mr. Secretary, but when I spoke with a particular family in Stockton, WI, someone who had owned a small gas station, automotive repair shop for many years and when asked about their tax cut for small business owners, I can tell you they did swear about the fact that they didn't receive one. So we have to be careful.

I mention all this as a precursor to my questions about the President's new tax favored initiatives, the new tax favored savings proposal. I will try to use statistics carefully here because I really do want to understand who will really benefit and at what cost.

I recognize the focus and the importance of increasing national savings, private savings, but I also note that these programs will ultimately drive us deeper and deeper into debt and from my examination will disproportionately enrich also the very most affluent in our country.

As I understand the analysis I have read of the lifetime savings account, when up and running, fully mature, the program would

provide the top 5 percent of the population with almost 50 percent of this account's tax benefits. The top 10 percent would secure almost two-thirds of that account's tax benefits. I also have information that suggests that the bottom 60 percent in this country would receive just 4 percent of this program's tax benefits. As I read on, I hear that with the retirement savings accounts, the results are supposed to be even more skewed. I want to dig more deeply into that.

I also understand that these programs, when up and running, the short term costs, the ones we see in the 5 year forecasts, are quite affordable and realistic but in the out years, the figures I see suggest that this will be \$50 billion a year when up and running. So I ask you first of all, if those comport with your out year estimates of the full cost of these when fully implemented and do you dispute or agree with the notion that the top 5 percent of income earners will essentially have 50 percent of these accounts' tax benefits?

Lastly, we know your own department says that under current law, only 4 percent of those eligible to contribute to IRAs actually max out per year; 5 percent who are able to do so with their 401(k) programs. Who would benefit more under these new proposals?

Chairman NUSSLE. The gentlelady's time has expired. You may respond to those questions.

Secretary SNOW. I will try and make a quick response.

I haven't actually seen numbers that you have cited. I would like to get them and give you our assessment. I just haven't seen those.

Ms. BALDWIN. I would be happy to provide you with those.

Secretary SNOW. And we will comment. What I know about the jobs and growth bill is—these are numbers we will be happy to share—that the burden of the tax bill is higher on high income people after passage than it was before. I think the top 5 percent went from paying something like 50 percent of the overall tax bill to paying 52 percent of the overall tax bill. I will give you our assessment and then we can have a statistician's discussion. I have not seen the \$50 billion number on these savings plans.

Our approach to this, our sense of this is, well off people have lots of ways to save. They have tax accounts and they have tax lawyers and they have disposable income and so on. People in lower income categories don't and they are more adversely affected by the restrictions in savings plans that limit the use of those monies because they are more likely to have a need to go in and use \$500 for an emergency because they don't have the overall liquidity that a person of greater wealth and financial attainment would have.

Our sense of this is it will disproportionately benefit poorer people in the sense that they aren't saving today and we are trying to give them vehicles to accumulate wealth, be a part of the so-called ownership society, and be able to take more direct control over their own financial lines.

We will share our data with you and yours with us and we can continue this discussion.

Chairman NUSSLE. Mr. McCotter.

Mr. MCCOTTER. Thank you, Mr. Chairman.

I have not a brazenly ideological question or a philosophical one, but more of a practical question. As one thinks about budgeting, budgeting really is a matter of priorities. Some budgets will produce operational deficits for however long, some will produce structural deficits. It seems to me that in both fiscal and most importantly in human terms, a budget that produces deficits and retains misplaced priorities is what results in the structural deficits and the long term negative growth projections in many ways.

It seems as I am 38 years old, although after serving on this committee I probably look like your older brother, I have grave concerns about the future myself. I grew up in the 1980s, came of age politically. I would like to know the parallels that you see between the budget deficit we are running now and the budget deficit of the 1980s because I believe there is a parallel there in terms of our priorities and how we place them.

In the 1980s, we saw that we won a cold war, we had an economy that was struggling in the early 1980s and improved over time and created long term structural growth which I think resulted in much of the positive economic activity of the 1990s and the peace dividend, of course.

Right now we are waging a war on terror and we have a struggling economy that we are trying to get going. Do you see parallels in terms of the priorities and the projections that you can base upon those priorities?

Secretary SNOW. Yes, Congressman, I think there are some striking parallels there. Starting with the cold war, the counterpart to the cold war is the war on terror. We have really had three major conflicts in the last half the last 60 years. One was the war on Nazism which caused large deficits as you know, then the cold war which reached its culmination in the Reagan years and now the war on terror. Each of those was a priority for the Nation and took substantial resources. In the first two, we were dramatically successful and that is the President's intention in the third, to be dramatically successful and rid the world of this heinous threat, something I think we all agree on.

The economy in the 1980s, I was early in my business career then, was struggling badly. I remember distinctly the recessions of the early 1980s and the effects it was having on business enterprise. I think those tax cuts clearly had an effect. The tax cuts got the economy going but at the price of a deficit, a deficit we later were able to work our way out of, in part because of the growth that came from my reading of the economic history, from the Reagan tax cuts in the Reagan years. That 1986 tax cut in particular I think was strikingly good tax policy. I wish we could get back to it in many ways, I would say aided by some very strong Democratic leadership made that possible. Senator Bradley comes very much to mind.

We also had in the 1980s a phenomenon that is different and that is we had low productivity. We had lost the engine of productivity of the economy for reasons that economists even today can't really pinpoint. Today, of course, we have the benefit of good productivity. We also had a difference since the inflation rates were a lot higher back then and now we seem to have dealt with the demon of inflation pretty well, but there are these striking par-

allels of an underperforming economy, tax cut responses that helped and overwhelmingly geopolitical engagement, then the war on communism and the cold war, now the efforts with respect to the terrorists.

Mr. McCOTTER. Thank you, Mr. Secretary. I would just like to note that in those 1980s, while I was in high school and in college, I heard that my generation would never see the Federal Government get out of debt or out of deficit spending and because we managed to win the cold war, we managed to get an economy going and in my lifetime, we saw a surplus again. I think if our priorities are correct in this budget, we will again in my lifetime and my children's lifetime.

Thank you.

Chairman NUSSLE. Mr. Moore.

Mr. MOORE. Thank you.

Welcome, Mr. Secretary. I want to repeat just a little of what I said to Mr. Bolton the other day and I am going to repeat some numbers I know you know.

We have a \$7.1 trillion national debt in this country, a \$521 billion deficit, almost \$1 billion a day in interest on our national debt, and the interest right now in our Federal budget is the third largest category of expenditure. It is money that could be used for health care for children, for education, for anything worthwhile besides paying interest. I think all of us would agree with that.

You said, Mr. Secretary, not quoting exactly but you can correct me if I am wrong, that we can afford to keep the tax cuts and higher tax cuts would be detrimental to the growth of our economy. I think that is close to what you said. I generally agree with that. But, Mr. Secretary, I want to ask you too, I look around and I see some of my colleagues—Mr. Putnam just left but I see some others, who probably don't remember the late 1970s. I think you do, Mr. Secretary. We had interest rates of 13, 15, and 17 percent. I think you would agree with me that would be absolutely devastating to business in our country as well real estate, the consumer borrowing, everything. It would be devastating to our country if that were to happen again.

This is not an exact quote but I think it is close. I think you said in your testimony, "deficits matter because if we don't act responsibly, fiscally, interest rates will or can go up." In fact, I have heard Chairman Greenspan when he has testified before the Financial Services Committee and this Budget Committee on which I serve, at least the 5 years I have been in Congress, say that several times, if not those exact words very close to that. I think you would agree with Chairman Greenspan.

I believe your testimony was that deficits are not large, growing, ingrained and entrenched. I guess there I beg to differ with you because I am getting very concerned that is what is happening in our country. The deficits are in fact becoming large. In fact, \$521 billion is the largest deficit we have ever had, maybe not in percentages but in terms of actual numbers, the largest deficit we have ever had, they are growing and we can hope that they get smaller next year but I want to see that before I will agree. To me they look like structural deficits. That is what really concerns me. We have heard Mr. Walker and others who are experts as well on the

economy warn against the dangers of that and I think Chairman Greenspan would as well.

I am going to hazard a guess here and I hope I am wrong, but maybe in the next 30 to 60 days, Chairman Greenspan may be giving some sort of policy address expressing his concerns about the prospect of increased interest rates. I agree with you it has been wonderful that we have the lowest interest rates in 40 years but I am very concerned, as I said to you, Mr. Secretary, that these interest rates—I know you would agree—we don't want them to take off but if it does, it is going to hurt every American, Republicans, Democrats, and especially our children. That is where I want to end and ask you a couple of questions.

I told Mr. Bolton I spoke to a high school class 2 weeks ago and said, why should you be concerned that we have a \$7 trillion debt and deficits that are growing instead of going down. One senior girl raised her hand, in a government class, and said, because we are going to have to pay it off. Her teacher said, she gets an "A" for today. That is a sad commentary on what we are doing because we have a national charge card and we are charging new tax cuts, we are charging spending on our charge card and saying to our kids and grandkids, here, you guys take care of it. I have told high school and college classes when I speak to them, you should be angry about that and you should contact your Member of Congress, your Senators and let them know you don't appreciate them spending right now for their own comforts and then passing the bill on to you in the future. That is not right. That is not morally right and we shouldn't do that to our future generations in this country.

In fact, President Bush said just one year ago on January 28 of last year, "This country has many challenges, we will not deny, we will not ignore, we will not pass along our problems to other Congresses, to other Presidents and other generations." Especially that comment about we won't pass on our problems to other generations, I fear that is exactly what we are doing here.

I guess I want to ask you what can we do. Mr. Moran, Mr. Spratt and others have asked you the question. I really want to be respect here because I do respect you but I am very concerned. Let me ask this question and you can answer it if you would. In this budget, there was nothing for Iraq. We know it is going to cost somewhere between zero and \$50 billion and maybe even more. I think we asked businesses when they have business plans to make an estimate, a projection or something, but we are not getting anything here. So \$521 billion could be a very low number, it could be over \$600 billion or more. How do we take comfort in that, Mr. Secretary?

Secretary SNOW. I think you might have had OMB Director, Josh Bolton, here yesterday and I think he responded that there will at some point be a need for a supplemental, probably not in fiscal 2004 as I understand but in fiscal 2005 and it certainly will not be zero. I agree with you. I think he indicated also it wouldn't be over \$50 billion I think that was the number he gave. I can't really do any better than that. You can fault us for not putting in some number but I think his response would be that the number we put in would be a made-up number. I wish we had a number but knowing that number is impossible at this time. I think if we had a

number, we would be perfectly delighted to share it with you and put it before you.

On your larger question: I agree with you—we can't pass these fiscal issues on to our children and grandchildren. Important as it is, and I think Chairman Greenspan would agree with me when I say this, as important as it is to get the fiscal deficit down to the levels we are talking about, doing that is not enough, really isn't enough because Congressman Spratt's charts show that the real problem is the unfunded commitments we have made to Social Security and to Medicare. Medicare is probably two-thirds of the problem, which is driven by demographics and rising health care costs.

The hope is on Social Security that Congress and the executive branch can help engender a national dialogue, talking to school children, college kids, and build an understanding on the part of the country that we need to take some steps to do it. I talk to kids all the time and I ask them, are you worried about Social Security? These are 20-year-old kids, kids my son's age. They say, no, I am not worried at all, why do you ask. I say, well, I just thought you might be worried about it. They say no, I am not worried about it, I am never going to see it, so why worry about it. That sort of flip answer they give you is because they have heard it from somebody else but it is out there.

Medicare is really the big one, it seems to me, because it drives so many numbers and that chart Congressman Spratt showed at the beginning of the hearing has a whole different inflection to it if you assume that we control Medicare costs. If you assume we can control Medicare costs, put Medicare costs at GDP plus one, you get a much better picture. If you assume could get Medicare costs growing at GDP, we are in balance. That is how big that change in assumptions is in driving those numbers.

I am completely in accord with your sentiments, and, I mean this sincerely, I look forward to working with you and other members of the committee to find answers both to the short term problem which I think is far less pressing than that long term problem that really drives the whole fiscal future of the country.

Mr. MOORE. Thank you, sir.

Chairman NUSSLE. Mr. Gutknecht is next but he has agreed to allow Mr. Hensarling to use this slot, so Mr. Hensarling is recognized.

Mr. HENSARLING. Thank you, Mr. Chairman. I thank the gentleman for yielding.

Mr. Secretary, to state the obvious, there appears to be a fair amount of anxiety by my colleagues to the left over the tax relief the administration proposed and which we passed last year. I thought I saw a release or a report from Treasury stating that tax revenues are up for the last quarter versus the same quarter last year. Did I read that report correctly?

Secretary SNOW. That is right.

Mr. HENSARLING. How can that be if we cut tax rates? How can we possibly raise more revenue?

Secretary SNOW. The bigger economy helps.

Mr. HENSARLING. Let me ask you this, Mr. Secretary. How much tax relief is being proposed by the administration in this budget?

Secretary SNOW. The tax relief being proposed in this budget primarily has to do with the savings accounts and I think that is on the order of \$60 billion to \$70 billion over the 10-year period and permanence, of course, but you said tax reductions. Permanence is avoiding a tax increase.

Mr. HENSARLING. How about if we add in the permanence, do you have a figure?

Secretary SNOW. Yes, that is around \$1 trillion.

Mr. HENSARLING. How much spending is proposed over the same 10-year period?

Secretary SNOW. Spending over that 10-year period is running at over—I think the revenue over that 10-year period is \$28 trillion.

Mr. HENSARLING. So you are saying, if I understood you correctly, making tax relief permanent and any new tax reductions is roughly \$1 trillion compared to \$28 trillion of spending. So those who wish to be focused on the Federal budget deficit, it would seem that most of the challenge is on the spending side. I didn't major in mathematics, but when I compare \$1 trillion to \$28 trillion, it seems like the preponderance of the challenge is on the spending side. Would that be your conclusion as well?

Secretary SNOW. Yes, I think that is why we said spending controls are critical here. We have the growth component going. If we can sustain the tax reductions, the economy will grow and there will be adequate revenues to fund the government if we control spending.

Mr. HENSARLING. I believe earlier one of my colleagues to the left said that tax reductions, if I got the quote right, go to the deficit bottom line. You said earlier we have had tax reductions, and we have actually increased revenue. Having been the veteran of one of these budget processes, I recall from last year Democrats proposed almost \$1 trillion more in spending over and above the budget we passed. Would that \$1 trillion of extra spending go to the deficit bottom line?

Secretary SNOW. That is the only place it can go to.

Mr. HENSARLING. We also heard discussions about various trend lines in the Federal budget deficit. I am concerned about the Federal budget deficit and with the exception of Mr. Putnam, I may have the youngest children of any member here, having a 23-month-old and a 4-month-old. So I think a lot about such things. At the end of the day, the difference between the deficit has to do with us paying cash versus us using a credit card. A credit card bill that I do not wish to leave to my children.

There is another budget that I am concerned about, the family budget. Over the last 5 years, Federal spending has gone from approximately \$16,000 per household to \$21,000 per household which I am led to believe is the largest 5-year spending spree since World War II. In speaking of trend lines and deficits, do you have an opinion about this trend line and what it might do the family budget deficit, Mr. Secretary, if we don't control spending?

Secretary SNOW. Your question suggests the answer. We have to control spending or else those numbers just get worse and worse.

Mr. HENSARLING. Thank you very much for your testimony. I yield.

Chairman NUSSLE. Thank you.

Let me inform colleagues that we are expecting votes at any moment. I am going to do my best to get all the questions in, please keep your questions and time for answers as best you can within that 5 minutes. When we vote, I am going to let the Secretary leave and we are going to move to the second panel. It has been a great hearing but I know that we don't want to keep him around for the votes.

Mr. Edwards is recognized.

Mr. EDWARDS. Thank you, Mr. Chairman.

Secretary SNOW, I keep hearing that we can continue to have trillion dollar tax cuts as long as we are tough on controlling spending and everything will be fine for our children's future. Let me ask you this question.

Seventy percent of all the dollars spent by the Federal Government, including the tens of thousands of Federal programs, 70 cents of every dollar goes into five programs—defense, Medicare, interest on the debt, Social Security and Medicaid. Let me just ask you a yes or no question to these. Is the administration in this budget asking for more or less in defense spending?

Secretary SNOW. I think it is 7 percent more for defense.

Mr. EDWARDS. And I support that increase. Is it asking for more or less for Medicare spending?

Secretary SNOW. The Medicare spending is an entitlement and it is not really directly in the budget. It will rise.

Mr. EDWARDS. But because of the prescription drug bill, it is going up, so that is two out of two. Interest on the national debt, one of the largest components of Federal spending programs is going up dramatically because of irresponsible fiscal policies and huge historic national debts, are we going to ask in this budget for more or less to pay the interest on the national debt this year compared to the year before?

Secretary SNOW. I think interest rate is up as the debt is up.

Mr. EDWARDS. OK. So in the first three out of the five largest Federal programs, the administration, despite all the rhetoric I hear from the other side of the aisle, is asking for more spending and frankly, I don't criticize that, I support more defense spending.

The other two programs, along with the first three, that the administration is asking for increased spending are Social Security and Medicare. In this year's budget, is the administration asking for reductions compared to the previous year's spending in Social Security and Medicare or increases in spending?

Secretary SNOW. Again, that is a mandatory program but numbers will go up.

Mr. EDWARDS. So those will go up. After all the rhetoric is put aside on the table, the five programs that represent 70 percent of every Federal dollar spent, this administration, not supported in many of those requests, but this administration, contrary to the rhetoric, is asking for an increase in certainly three, defense, Medicare and interest on the debt and most likely in effect, Social Security and Medicaid expenditures will go up.

Let us look at some others. Highway spending, is this administration going to ask for more or less in highway spending compared to the previous year?

Secretary SNOW. I think it is modestly up.

Mr. EDWARDS. That is modestly up. Veterans, the budget actually cuts real services to veterans but in terms of actual nominal dollars, before you consider health care inflation, is the administration asking for more or less in veteran spending compared to the previous year?

Secretary SNOW. I think it is a little more.

Mr. EDWARDS. So if you take the five programs that represent 70 percent of every Federal dollar spent, add highways and veterans which represent another significant part of the budget, the truth of the matter is, American people need to understand, that even these budget hawks that want to be so tough and have such a sharp knife on cutting spending, we are actually asking for increased spending.

That is exactly why when President Reagan said in 1981, we could have massive increases in defense spending, massive tax cuts and balance the budget, he was \$2 trillion off in a decade and we tripled the national debt.

I have to talk a little bit about the credibility gap. I understand economics is an inexact science and I understand these budget annuals are beyond the ability of most Americans, myself included, to really analyze in great detail. I respect the gentleman's economic experience and life work. The American people have a right to ask about the credibility of predictions, so let us go back historically, 20 years prior to 2001, 1981. President Reagan did make that promise—increased defense spending, massive tax cuts, balance the budget. Guess what happened? We didn't balance the budget, we tripled the national debt.

Fast forward 10 years later. Former President George Herbert Walker Bush made a campaign promise, "read my lips, no new taxes," but to his everlasting credit, probably at the expense of reelection, he looked the American people in the eye and said, protecting our children and grandchildren's economic future is more important than a campaign promise.

Fast forward 10 years and because of that President Bush was part of a bipartisan effort to increase taxes to lower the future projected deficits. Come 20 years after President Reagan made his promises, which David Stockman said he knew were not true, that you couldn't do all three of those things without creating massive deficits, President Bush promises in 2001 we can increase defense spending massively, cut taxes massively and balance the budget. President Reagan was wrong and Congress was wrong in 1981. President Bush is wrong this time and frankly, I think we have a credibility problem, Mr. Secretary.

Chairman NUSSLE. Mr. Gutknecht.

Mr. GUTKNECHT. I would let the Secretary respond to that if he would like to.

Secretary SNOW. Thank you, Congressman Gutknecht.

I would simply respond that the Reagan years produced phenomenal benefits for the world and the country in ending the cold war and bringing the wall down, reuniting Germany. I don't think anyone wants to quarrel with the extraordinary success of what was accomplished on Ronald Reagan's watch.

The deficits, and you have probably studied this more recently than I have, but as I recall during the Reagan years, he did pro-

pose fairly tight spending controls and Congress didn't give him the spending that he wanted and that contributed very much to the deficit that occurred. I don't want to go back and argue history with you. It is a combination of good tax policy and good spending policy. You get them right, you get good results. I think the President's budget reflects good policy on taxes and I think it reflects good spending.

I wish we weren't in the situation we are with the war on terror and homeland security because that drives this budget. I don't think you are criticizing it so much, as you are just pointing out that the spending goes up and it does. It is regrettable but it is for a cause that I think is awfully important and I think you will agree.

Mr. GUTKNECHT. Reclaiming my time, and since everyone is engaging in a little bit of historical revisionism, now it is my turn and maybe I can put our spin on the story.

I was first elected in 1994 and when I came here, I will never forget, the first meeting we had with some of the CBO economists. They told us we were looking at a minimum of \$250 billion deficits for as far as the eye could see. They were wrong. About 3 years ago, we were told by some of the same economists that we were looking at \$4.5 trillion worth of surpluses over the next 10 years. They were wrong. The only thing we can honestly say about the projections we are looking at today is they are wrong. We don't know if they are high or low but we know they are wrong. I do agree with you on this, that we have to keep our eye focused on the spending side. Frankly, some of the criticism you have heard today is not that the administration is being too tough, the criticism I think really is are you going to be tough enough.

Ultimately, it seems to me we have to get hold of some of these big entitlements—health care costs. The bottom line is this, and my biggest employer is a little medical practice started by two brothers named Mayo and they are a very important part of our economy. Health care is extremely important to every single American. The bottom line is we can't have a health care delivery system that is taking 15 percent of our gross domestic product and going up. At some point, we are going to have to get our arms around that.

The same is true of Medicare and ultimately, let us not kid ourselves. Those kids are right. We have to get some kind of real Social Security reform. Frankly I think the budget you are presenting is, in my opinion, a little bit too timid.

I do want to come back to another issue. I will help you all I can on the budget issues to get control of Federal spending, both on the entitlement and on the other side of the budget equation, but I want to come back to something you said that I think is important. I apologize, this is a bit parochial but it affects an awful lot of people. You said something about making pensions stronger in your opening remarks. I would like to know more about what you are saying. More importantly and to the point, I really want to know more about the administration's position on this whole issue of pension conversions. This is a very big issue. I have 6,000 current and former IBM employees in my district and it affects a lot of Americans and there is a lot of angst out there.

I would like to work with you, I think I have offered a very reasonable compromise on this issue but it is a big deal and affects everybody. If the administration is serious about making pensions stronger, I have a couple of very specific recommendations.

While you think about your answer, Secretary Snow, I do want to welcome, for the benefit of all the members in the back of the room, we have several members of the German Parliament who are here with us today, including a member of the Hungarian Parliament who are here in Washington. Perhaps we can give them a welcome. [Applause.]

And you have 20 seconds left.

Secretary SNOW. We will look forward to working with you on the pension issue. I think you are referring to the cash balance pension plans and the conversions to cash balance pension plans. I think we have sent up by now a proposal or we are in the course of doing it, I have signed off on it. It is in the budget, good, that deals with that issue by providing for continuation of cash balance pension plans but only where the employer treats the older workers equitably. We deal with the wear away problem that you are referring to and in effect, hold older workers in the same position they would have been if they had stayed with the employer, with their old DB plan for 5 years.

Mr. GUTKNECHT. Not having seen that, that sounds like a very fair compromise. Again, I look forward to working with you.

Chairman NUSSLE. If we are quick about it, we can get two more questioners in.

Ms. Capps.

Ms. CAPPS. Thank you.

Mr. Secretary, I would like to turn to the topic of tax credits for the uninsured. In testimony before the Committee on Ways and Means last year, Jonathan Gruber, a professor at MIT, presented an analysis which showed that the tax credit proposal would only reduce the number of uninsured by 1.9 million, out of 44 million uninsured. In addition, of the 4 million who will take advantage of the tax credit, according to the administration, almost half or around half already have some form of insurance.

My question is, why would the administration tout a policy that only helps 5 percent of the uninsured, many of whom have insurance and call this the centerpiece to its uninsured agenda? I am wondering, in addition, is it really cost effective to spend \$70 billion for such little effect?

Secretary SNOW. We would have little different numbers than the professor. I think our number is somewhere between \$4 million to \$5 million, so we would see our program being a little more effective.

Ms. CAPPS. Still, 4 million out of?

Secretary SNOW. Out of 444 [million].

Ms. CAPPS. Maybe it is appropriate to focus on what this tax credit could buy on the insurance market. This is according to the GAO. In 1998, the mid range premium for family insurance in the individual market exceeded \$7,300. It is probably higher now. Further, a Commonwealth fund study that looked at individual health insurance policies found that the median annual premium for a single, healthy adult aged 55 was \$6,100. Keep in mind in this

budget, the President is proposing tax credits of \$1,000 for individuals and \$3,000 for families. These tax credits, I submit, will do little to make health insurance more affordable for eligible families.

My question again is how would this tax credit help low income families buy health insurance when they are still left with such a large premium that they can't afford?

Secretary SNOW. I have looked at this question and I am not as knowledgeable as you are with your background in health care, but I don't think there is any silver bullet that deals with all 44. It is a complex issue. This only deals with a piece of it, there are other proposals we have, the deductibility, above the line, high deductible plans, the HSAs that the Congress approved should help but I think it is a problem we have to keep coming up with tailored solutions because there isn't a one size fits all sort of answer.

Ms. CAPPS. I grant you this is not a silver bullet. I haven't even brought up and maybe we should that it is really difficult for older individuals and those in less than perfect health to buy health insurance. If any of us in this room have ever tried to buy health insurance on the individual market, in the rare instances that people can do it, affordable premiums and deductible are out of reach. There is no silver bullet but in this budget, you are proposing \$70 billion for tax credits for health insurance that won't help many of the 44 million insured. This is not only cynical but a tremendous waste of resources. I submit that we should be looking and I wonder if you have other ideas for more effective ways to address the needs of the uninsured?

Secretary SNOW. I think there is one effective way to deal with it and that is only one. This won't surprise you but it is to narrow the gap between the path health care costs are on and the path which disposable income is on. You do that two ways. You lift the path for disposable income and you reduce the path for health care costs.

Ms. CAPPS. How do we reduce the path for health care?

Secretary SNOW. I would suggest right away that we go after malpractice abuses. Medical malpractice abuses are having a disastrous effect on health care quality and health care costs in the country. That is where I would start.

Ms. CAPPS. I yield back.

Chairman NUSSLE. I thank the gentlelady.

Mr. Diaz-Balart. You can see the time on the screen as well as I can.

Mr. DIAZ-BALART. I will be brief, Mr. Chairman.

Mr. Snow, you are probably as amazed as I am, I haven't been here that long either, of hearing from our dear friends on the minority side on one hand that the deficit is too high, therefore we are spending too much more than we are bringing on and on the other hand, that we are not spending enough. I guess the answer to that is well, they say we have to reverse the tax cuts, i.e., increase the taxes on the hardworking Americans.

My question, to be brief, is what do you think the outcome would be if in fact we reverse those tax cuts of the past few years, in other words if we raise taxes, what would be the adverse effects on the economy, if any, and to what degree?

Secretary SNOW. I think the consequences of that would be very serious on economic growth, on the incentives to save and invest, unemployment levels. There just can't be any doubt about the fact that the tax cut you approved last year has put the economy on a much, much stronger path. We wouldn't have seen 8 percent growth rates in the third quarter if it hadn't been for the tax cut. We wouldn't have seen 4 percent in the fourth quarter. We wouldn't have had the 26 percent growth in the equity markets. We wouldn't have manufacturing coming back and exports coming back as they are and they clearly are, without the effect of those tax cuts. It would be a shame to reverse that course.

Mr. DIAZ-BALART. Thank you, sir.

Thank you, Mr. Chairman.

Chairman NUSSLE. I thank the gentleman.

With that, Mr. Secretary, we are going to go to a vote. We have three votes on the floor and we appreciate the access we have to you and for your valuable time and attendance at these meetings. If I could put I none final pitch, Mr. Smith knows my passion in this regard, we need better revenue forecasts. My understanding is there have been some ideas floating in Treasury for ways that we can help you help us with those forecasting measures. If you would give a proposal, I can tell you that myself and many others are interested in helping you help us with the revenue forecasting issue. We stand ready to serve in making sure we can get better numbers.

Secretary SNOW. Mr. Chairman, maybe with that admonition to us, Secretary Olson will reconsider her decision to retire.

Chairman NUSSLE. That would be nice, but your entire team knows our passion for that and we appreciate your work in that regard.

With that, we will stand in recess. There is a second panel. We will reconvene after the final vote in this series.

[Recess.]

Mr. SHAYS [assuming Chair]. I would like to call this hearing to order and to thank you, Mr. Aaron, for your patience on the day that members go home and after a Secretary has come, sometimes the room is somewhat sparse but your message is very important. The advantage we have is that we don't have to follow the 5-minute rule and we can make sure what you have to say is out, the story is out. So we are going to hear your testimony and welcome that and I will start with Ms. Baldwin.

**STATEMENT OF HENRY J. AARON, BRUCE AND VIRGINIA MAC LAURY SENIOR FELLOW, THE BROOKINGS INSTITUTION**

Mr. AARON. Thank you very much, Mr. Shays. I appreciate the invitation to come here and perhaps there are advantages to a cozy setting. At least I hope so.

You have a copy of my testimony and I am going to try to go through all of the points I covered in it but I would like to hit a couple items and there are a few other issues that arose either yesterday or today that I would like to spend a bit of time on.

The first point which I covered in my testimony is that I think most informed observers would agree that official projections grossly understate the size of the budget problems the Nation faces. The

current conventions incorporate assumptions that directly contradict stated policy of the administration, including extension of the 2001 and 2003 tax cuts, relief for the alternative minimum tax and as we just heard from Secretary Snow and you heard yesterday from OMB Director Bolton, a supplemental for national defense.

The official projections also treat the temporary cash flow surpluses in the retirement programs as if they were available legitimately to finance current activities of government and I believe they conceal the size of the imbalance between revenues and outlays in the rest of the budget. If one takes those adjustments into account, the proper measurement of the 2005 deficit is well over \$600 billion and will not decline but will increase in the years ahead under stated administration policies reaching close to \$1 trillion a year and an annual rate in 2014 despite of the assumption of full economic recovery, a return to full employment and a continuation of the rapid productivity growth we have enjoyed since the late 1990s.

Affirmation of the tax cuts enacted over the past 3 years represents a decision, an explicit priority decision as one of the members noted earlier today, and it is a decision that we should use funds that we need to pay for public assumption instead to go back to individual pockets to finance private consumption.

Over the long haul, the revenues sacrificed through these tax cuts are more than sufficient to deal with urgent problems that I believe all Americans want to see solved. The revenues foregone by the tax cuts are three times as large as those needed to close the entire projected deficit over 75 years in the Social Security Trust Fund.

Mr. SHAYS. Could you repeat that?

Mr. AARON. The size of the tax cuts enacted in 2001 and 2003 calculated over the next 75 years are three times as large as the entire projected deficit in the Social Security system. To put it in other terms, you could if you wanted retain two-thirds of the tax cut but not all of it, divert the rest of it to correcting the shortfall in Social Security and be no worse off than if you would under administration policy. This raises a question of priorities squarely. Which do we want? Do we want to finance that much more private consumption or do we want to at least use part of that to help deal with recognized national problems?

An additional point I stressed in my testimony I would like to repeat here is that I believe the proposed reforms in budget procedure that the administration advances are unbalanced and are not likely to work as intended. The administration would place procedural obstacles in the way of any increase in entitlement spending or in refundable tax credits but there would be no procedural obstacles to further tax cuts in the positive income tax..

The old pay go rules that Congress worked under during the 1990s were far more even handed. The same rules, in my view, should apply both to entitlements and to tax reductions of any kind.

In addition, the baseline that the administration proposes for discretionary spending amounts to a 15 percent reduction in real per capita spending for domestic discretionary activities. It would rep-

resent a 20 percent cut in the share of national income devoted to this function. Again, limits are necessary and I am not in any way arguing against them but they should not be so far outside the range of policies that both Congress and the administration have clearly embraced. I include not just the previous administration but this administration and this Congress.

Reducing the deficit is important as I think everyone agrees because it frees up private saving for productive investments, adds to national income, increases earnings and reduces the share of the budget that has to go to pay off interest on the national debt. A balanced program is going to include both spending cuts and tax increases. To be sure raising taxes increases associated economic distortions as I think members of both parties generally agree but there is ample room to raise taxes in ways that actually reduce economic distortions.

Furthermore, some economists, rather shrilly in my view, said after the tax increases enacted in 1993 that they would cripple economic growth. What in fact ensued was the longest economic boom in U.S. history and large increases in the rate of productivity growth. Furthermore, cutting spending carries costs too. For example, a failure to provide health care for the disadvantaged or a failure to clean our environment. There are losses suffered either by raising taxes or by cutting spending but in both cases, they are necessary to help restore fiscal discipline for the Nation's budget.

Finally, some have defended proposals to make the tax cuts permanent by saying that doing so would reduce uncertainty. With all due respect to the people who have made this argument, I believe it is laughable. Does anyone here really think that American workers are seriously deterred from looking for work or improving their skills by the prospect that tax increases might rise in the year 2010? In the case of businesses, there is more substance to the concern. Businesses do depend on a stable environment to make long term plans.

You can best reduce uncertainty for business by assuring them that exploding government deficits will not produce financial market meltdown and one effective way to do that would be to state clearly that the tax cuts will, for the most part, be allowed to expire, no question about it, no uncertainty, you can count on it. It would be even better if that announcement were part of a comprehensive program including sensible spending cuts and sensible tough budget rules.

I would like to just mention two points that came up in Secretary Snow's testimony and in the questioning thereafter. In responding to Ranking Minority Member Spratt's reference to the charts from the special analysis volume of the budget which showed steady deterioration of the budget in the future, Secretary Snow said, "but if we could only bring health care spending down for example, so that it would not be faster than the growth of GDP plus 1 percent, things would look a great deal better."

In fact, those projections incorporate precisely that assumption. That assumption indeed is over optimistic. It is over optimistic because the growth of health care spending for decades has proceeded at a faster rate than that. The message is that we already have in

the projections graph in the special analysis volume a picture that is unduly optimistic, serious and threatening though it appears.

The second point referred to the question of the source of our current budget deficit problem. Is it attributable primarily to revenue issues or is it attributable primarily to spending excesses? Here are the key facts. In the last 4 years, the budget has moved from surplus to deficit for a total shift of 6.6 percentage points of GDP. Of that shift, 5 percentage points is attributable to declining revenues, 5 percent; 1.6 percent is attributable to increased spending. Of that 1.6 percent, all but 0.4 percentage points is attributable to defense and homeland security and only four-tenths of 1 percent of the deterioration of the budget is attributable to increases in non-defense discretionary spending. Spending in fact for the Government as a whole is running below the average of the last 20 years.

I think for that reason, it is a mischaracterization to attribute our current deficit problem to spending that is out of control. We have serious revenue problems. To balance the budget we will need to cut spending but on balance, if there is indiscipline, it has occurred more on the revenue than on the expenditure side of the budget.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Aaron follows:]

PREPARED STATEMENT OF HENRY J. AARON, BRUCE AND VIRGINIA MACLAURY SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. Chairman, thank you for the invitation to testify today before this committee on the current state of the U.S. Government's budget and on the proposals contained in the administration's proposed 2005 budget.

Presidents often begin State of the Union messages with some variation on the phrase "The state of the Union is strong." In the same spirit, I shall begin my testimony with the statement "The state of the Federal budget is perilously weak and getting weaker. It is on its way to becoming a threat to national economic and political stability." To this I would add that the administration's proposed 2005 budget would make that situation worse, not better.

I understand that these are strong words and that not all respected economists would agree with them. I also realize that disagreement among supposed experts puts those who depend on expert testimony in a difficult situation. When experts disagree, why not just wait and see if time clarifies matters? Mr. Chairman, you and your colleagues do not have that luxury. You are in the position of a jury judging a difficult case of transcendent importance. You will hear the evidence, and you must reach a verdict, a verdict of action.

In my testimony, I shall try to make the following points:

- The deficit in calendar year 2004 is large, but not unprecedented for a recession year. It is not a serious problem and should absorb little of your attention. Indeed, any belated effort to reduce this year's deficit is neither likely to succeed nor desirable to undertake, as it could hinder recovery from the recession.
- The deficit projection over the next 10 years is distressingly bad. Official statistics do not come close to representing how bad it is for two reasons: official projections are based on conventions that everyone understands to be misleading; those projections focus on the unified budget, which misrepresents the long-term implications of current budget policy.
- The budget situation has deteriorated catastrophically over the past 3 years. Events beyond the control of economic policy makers account for much of this deterioration, but persistently bad fiscal policy has aggravated the damage from these unfortunate external events.
- Although budget prospects for the next decade are bad, they become far worse in later years as retiring baby-boomers push up pension and health outlays.
- The time to begin repairing the fiscal damage inflicted on our economy is now. For economic reasons a program of fiscal rehabilitation should and for political reasons must, include both spending cuts and tax increases. The mix will depend on the priorities of the American public, but no responsible cure for America's fiscal problems can exclude sizeable tax increases.

- The program outlined in the administration's 2005 budget fails distressingly to meet the challenge. Rather than calling for needed tax increases, it calls for still more tax cuts. It focuses on the wrong target, the unified deficit, which badly understates the size of the deficit problem the nation confronts. Simply maintaining current services would reduce spending more than the administration's budget would do. Furthermore, spending will almost certainly be higher and tax collections lower than stated in the budget if administration policies are adopted.
- The changes in budget procedure that the administration proposes to control deficits would constrain nondefense spending increases, which account for little of the deficit problem over the next decade, and do nothing to forestall cuts in revenues, erosion of which accounts for most of the problem.

#### I. THE CURRENT DEFICIT IS NOT A PROBLEM

The Congressional Budget Office estimates that the unified budget deficit for fiscal year 2004 will total \$477 billion, somewhat below the administration's estimate of \$521 billion. This number is misleadingly small because it includes as revenues available to cover current spending \$170 billion in revenues counted as additions to Social Security and Medicare Hospital Insurance Trust Fund reserves. All of these cash flow surpluses and more besides will be needed to honor currently promised benefits. A better indicator of the size of this year's fiscal shortfall would exclude these accumulations. If these trust fund additions are not included, the CBO estimate of the budget deficit balloons to \$647 billion and the administration's deficit is approximately \$685 billion.

These deficits, 5.7 and 6.0 percent of projected GDP, respectively, are about as large as were the unified budget deficits in the 1980s, when Social Security and Medicare cash flows were about in balance. Pointing to the unified deficit, some people poo-hoo this year's deficit as much smaller than those from which the nation suffered during the 1980s. Those claims are misleading because they disregard the fact that the nation was in the 1980s suffering from a much more serious and persistent recession and because they treat funds that are being collected and will be needed to meet future obligations as available for current use.

That said, this year's deficit is not a major concern. Revenues fall during recession, and the recession is not yet clearly over. The very fast growth during the third quarter and the slower, but still encouraging, growth during the fourth quarter of 2003 have not sufficed to produce job growth. The small drop in the unemployment rate is due more to discouraged workers giving up and leaving the labor force than to job creation. Workers continue to exhaust unemployment benefits at record and increasing rates. And auguries for the sustainability of the current recovery remain mixed. In this situation fiscal managers, in my view, should follow a strategy similar to that announced by the Federal Reserve's Open-market Committee of continuing to allow highly stimulative policies to remain in effect until the recovery is undeniably under way.

Current policy remains flawed. The stimulative tax cuts of the past 3 years could have been designed far more effectively to combat the recession. Reductions in dividend taxes, in capital gains rates, and in marginal tax rates applicable to high-income recipients, who spend a relatively small fraction of their incomes, do far less to stimulate the economy than would tax cuts of equal size directed to recipients of low and moderate incomes, who spend virtually all of their incomes on current consumption. But that legislation is on the books, and Congress should, in my view, look ahead, not back. As I shall argue presently, most attention should be devoted to the long-term budget situation. But in looking ahead, Congress should not leave unattended two urgent near-term problems.

The first is the plight of the unemployed who are exhausting their benefits at record levels an estimated 2 million during the first half of 2004 and whose job prospects remain cloudy. The situation is not equally serious everywhere, but the number of unemployed exhausting their benefits is higher than average in every state in the union and higher than it has been for decades in nine states.

To pick just two states not entirely at random, an estimated seventeen thousand Iowans (the third highest number for any corresponding period in the last twenty-nine years) and nearly 28,000 South Carolinians (the highest number for any corresponding period in the last thirty-two years) will exhaust their benefits.

The second is the fiscal problem confronting state and local governments. Because of a recession states did not cause and cannot fight, state revenue growth has fallen far behind projections an estimated \$57 billion less in 2005 than if the recession had not occurred. The result has been 2 years during which balanced-budget requirements have forced large reductions in public services. Additional deficits are pro-

jected for 2005 of roughly \$40 billion, more than 8 percent of baseline general fund spending.

In those same two not-randomly selected states, the projected deficits are 7 percent of general fund spending in Iowa and 6-10 percent in South Carolina.

Nor is profligate spending the cause of state fiscal problems. Over the decade from 1989–99, real spending by states grew at an annual rate of only 2 percent. From 2002–05 Federal policies have imposed net costs on the states collectively of an estimated \$165 billion. The states at first tried to maintain public services by running down rainy day funds, then cut spending and raised taxes.

The result has been stark: loss of health benefits for more than 1 million low-income people, more than 1 million of whom are children, cutbacks in day care that is necessary to make effective the work requirements under TANF, cutbacks on funding of primary and secondary education, and reductions in support of higher education, resulting in double-digit tuition increases.

Rather than helping the states, however, the administration's proposed budget would add to their burdens. It reduces the real value of grants to the states by about \$3 billion.

Constituents should ask for an explanation from those Members of Congress who supported tax cuts for high income families, but who refuse to support extending unemployment benefits for the long-term unemployed or additional fiscal support to enable states to provide health benefits for poor children, books for school children, and day care for children of mothers required to work. Even if one rejects any spending that would further increase the deficit, one can still ask what value system would lead an elected official to put tax cuts that add to the disposable income of the wealthy ahead of grants that would maintain health care for poor children and education for all because those are the priorities that policies advocated by this administration and passed by this Congress have expressed.

## II. OFFICIAL BUDGET PROJECTIONS SERIOUSLY UNDERSTATE THE NEXT DECADE'S DEFICITS

Between 2005 and 2014, the Congressional Budget Office anticipates cumulative unified budget deficits totaling \$1.893 trillion. According to CBO projections, large early deficits give way to a small surplus in 2014. This projection follows well-established conventions and, based upon those conventions, is done with complete professionalism.

The CBO and the corresponding administration projections of the unified budget deficit are, however, a misleading guide to the fiscal challenges that the nation faces. To base current economic policy on those projections would be a serious error. The problem is that the CBO unified budget projections focus on the wrong target and are based on implausible assumptions.

The Wrong Target. In fiscal year 2005, the CBO's projected unified budget deficit consists of three components:

- Social Security cash flow surplus of \$171 billion,
- Medicare Hospital Insurance cash flow surplus of \$18 billion, and
- non-Social-Security-non-Medicare-Hospital-Insurance deficit of \$551 billion.

Every nickle of the cash flow surpluses in Social Security and Medicare and much more besides will be needed to pay for future benefits, as both programs confront projected, long-term deficits. Furthermore, every nickle of the payroll tax collections that make those surpluses possible is justified on the grounds that it will help pay for future benefits. Excluding those cash flow surpluses in computing the current budget balance of the nation provides a more accurate indicator of the nation's fiscal shortfall than does the unified budget deficit. Using that measure, the CBO's projected cumulative deficit from 2005–14 is not \$1.893 trillion, but \$4.438 trillion.

Implausible Conventions. But even that measure is far off any reasonable projection of what is likely to occur, as shown in several papers by my colleagues William Gale and Peter Orszag (alone and with various co-authors). Because Peter Orszag testified before you yesterday, I shall only summarize the major points.

The official projections of both the Congressional Budget Office and the Office of Management and Budget are based on the following assumptions: that expiring tax provisions (including all of those enacted during the last 3 years with sunset dates) are allowed to expire on schedule, that nothing is done to soften the effect of the spreading reach of the alternative minimum tax, and that real discretionary spending (defense and nondefense combined) will be unaffected by either population or income growth.

Dropping these assumptions produces disturbingly higher projected deficits:

Concept	Projected Deficit, 2005–2014
Unified Budget .....	\$1.893 trillion
Excluding Social Security and Medicare .....	4.438 trillion
Adjusted for expiring tax provisions and AMT adjustment .....	7.451 trillion
Adjusted to hold real discretionary spending per person constant .....	8.035 trillion
Adjusted to hold discretionary spending/GDP constant .....	9.002 trillion

The starting point for discussions of the nation's fiscal challenge should not be \$1.893 trillion, but somewhere between \$4.438 and 9.002 trillion. Since the administration has made clear its desire to make the tax cuts permanent and, presumably, would not want the minimum tax to deny filers the tax cuts that it deems so beneficial, the starting point is well over \$7 trillion. If one supposes that spending on national defense will not sink materially and that some increase in real, per capita nondefense discretionary spending will occur, the budget problem is somewhere in the \$7–\$9 trillion range. In other words, over the decade from 2005–14, the budget challenge is roughly four times as large as the CBO's projection of the unified budget deficit would suggest. Furthermore, the deficit with these adjustments does not diminish, but increases steadily, approaching \$1 trillion in 2014 alone.

False Hopes. Some observers downplay the significance of prospective budget deficits by claiming that past deficit projections have been widely off the mark and that we can grow our way out of the current mess. This position is dangerously irresponsible.

That budget projections are unreliable is well established. It was not only the courageous bipartisan deficit reduction programs enacted in 1990 under President George H. W. Bush and a Democratic Congress, in 1993 by President William Clinton and a Democratic Congress, and in 1997 by President William Clinton and a Republican Congress that eliminated the deficits spawned in the late 1970s and early 1980s. The economic boom of the late 1990s and the revenue bonanza it produced did much of the work. Why couldn't we get lucky again?

Well, we could. But three considerations warn that we should not count on it.

The first is that the budget projections of the Congressional Budget Office and the administration already build in faster productivity growth than was assumed or achieved throughout the 1980s and the early and mid 1990s. These higher productivity assumptions reflect the improved economic performance of the United States since the late 1990s and are fully warranted. Still higher sustained growth is conceivable. Based on historical trends, however, it is unlikely. Furthermore, even if higher growth were realized, the administration's own calculations, shown on page 194 of the Analytic Perspectives chapter, "Stewardship," indicate that modest increases would not solve the nation's long-term budget problems.

Second, the last productivity surprise followed two decades of courageous and far-sighted economic policy, beginning with The Tax Reform Act of 1986 enacted during the administration of President Reagan, and continuing with the three deficit-reduction packages passed in 1990, 1993, and 1997. To count on even higher productivity growth than is already built into budget projections following budget policies that studies carried out by the Congressional Budget Office and outside analysts indicate are more likely to lower productivity growth than to raise it, is neither prudent nor responsible.

Third, it is simply irresponsible to count on good luck to bail us out of clearly foreseeable problems. Yes, productivity growth could be higher than currently assumed. It could equally well be lower. Economists still do not fully understand why productivity collapsed in the 1970s, and they cannot fully explain why it rose in the late 1990s. To blithely invoke a jump in economic productivity as a budget savior when there is no good reason to foresee it is foolhardy.

### III. EVENTS AND BAD POLICY HAVE COMBINED TO CREATE THIS FISCAL PROBLEM

When CBO made its 10-year unified budget projection in 2001, covering the period from 2002–11, it foresaw a cumulative surplus of \$5.6 trillion. It now foresees a cumulative deficit for the same 10 years of \$2.9 trillion. The total budget deterioration is \$8.5 trillion.

Of that deterioration:

- 27 percent is attributable to the tax cuts,
- 19 percent to increased spending on defense and homeland security,
- 15 percent to increased spending, and
- 39 percent to changed economic and technical assumptions.

This apportionment of causes of the deficit shows clearly that the recession contributed in a major way to the deterioration of the budget situation, principally because it has led to a huge and still incompletely understood reduction in revenues. The uninvited, but necessary, increases in spending for defense and homeland security also contributed to the budget turn-around. But the various tax cuts accounted for \$2.4 trillion of the red ink and will add far more in the years after 2011 when recession plays no part in projected deficits.

To argue, as the administration does, that the budget would be in deficit even if taxes had not been cut, makes no sense, because that is not the issue. The question, rather, is whether, given the difficult hand that economic events and the terrorist threat have dealt us, it makes sense to make an already bad deficit situation worse by cutting the taxes needed to pay for government services Congress has approved.

The answer is that imprudent tax cuts have made a difficult situation worse. This characterization is fair because opponents to the tax cuts specifically warned that the economic weather could deteriorate in the future as it had in the past. Disregarding such warnings, the administration relentlessly and rashly insisted on cutting taxes and Congress unwisely concurred. We are now reaping the consequences of this improvidence.

It is also misleading to argue that the source of budget problems is “out of control” discretionary spending. Between 2000–04, government spending rose by 1.6 percent and revenues fell by 5 percent of gross domestic product, a total swing from surplus to deficit of 6.6 percent of GDP. Of the increase in spending, about three-quarters was for defense and much of the remainder was for homeland defense. Nondefense discretionary spending rose by about 0.4 percent of GDP, thereby accounting for about 6 percent of the deterioration in the budget. Whether those increases were wise or foolish, I leave to others to debate, but anyone who claims that explosive spending growth is the source of our current deficit problem or the one that the nation will face over the next decade should not be taken seriously. The deficit problem, overwhelmingly, is attributable to declining revenues, which have fallen in part because of the recession and in part because of tax cuts that Congress has enacted.

#### IV. THINGS GET WORSE

As is well known, budget prospects over the next several decades deteriorate dramatically. CBO projections indicate that Social Security, Medicare, and Medicaid spending as share of gross domestic product will rise by 3 percentage points of GDP between 2010–20 and by an additional 5 percentage points between 2020–40 under current policy, a total of 8 percentage points of GDP over the three decades from 2010–40.

Despite irresponsible rhetoric to the contrary, it will be impossible to offset this increase solely by program cuts, program redesign, or improved efficiency. As the recently enacted Medicare amendments demonstrate clearly, pressures to liberalize health benefits for the elderly and disabled are strong. And with good reason. Even after the drug benefit is implemented, Medicare will continue to provide far narrower coverage than does the health insurance enjoyed by the majority of the non-elderly. Retrenchments in private retiree health benefits and skyrocketing Medigap premiums, as well as inadequacies in Medicare coverage will sustain pressures to liberalize, not curtail government-sponsored benefits. It will take great effort and substantially increased cost sharing by upper-income elderly and disabled simply to stay within current frightening projections.

Some cuts in Social Security benefits are possible and desirable as part of a program to restore long-term financial balance, but total spending is bound to increase as a share of GDP as the baby-boom retires.

Against this background, it is fair to enquire whether making the tax cuts permanent is the best possible use of the funds that higher rates would generate. The long-term cost of the tax cuts enacted in 2001 and 2003 is three times the cost of closing the seventy-five-year deficit in Social Security and more than sufficient to close not only that deficit but also that in Medicare Hospital Insurance. Given the choice, the American public might well prefer to devote at least some part of the revenues that will be generated as the tax cuts expire to reforming and restoring balance in Social Security and Medicare. In addition, it is quite odd that an administration which has emphasized the importance of taking account of the size of the multi-trillion dollar long-term shortfall in Social Security and Medicare fails take account of the even larger multi-trillion dollar long-term cost from making tax cuts permanent.

The demands on the public sector over the coming decades confront the United States with a challenge that few democracies have been able to handle. Congress and the American public will be forced to choose among three broad options:

The first is to raise total tax collections by 40–50 percent from the current level of just under 16 percent of gross domestic product to roughly 25–28 percent of gross domestic product.

The second is to slash pension and health benefits for the rapidly growing numbers of elderly and disabled and to withdraw the safety net under the poor. Please note that privatizing these services offers no fiscal relief whatsoever. Either benefits must be cut or dedicated revenues must be increased; those are the only options.

The third is to run huge deficits that would quickly destroy the willingness of financial markets to lend to us and amount to economic suicide for this nation.

None of these choices is palatable, but there are no others. The nation is likely not to rely on any single one of these options. If it behaves responsibly, however, it will not use the third, but will choose some combination of tax increases and reductions in pension or health benefits and not rely at all on the third option. I am not here today to embrace any particular approach, but rather to point out that the stress of choosing among what may now seem unthinkable alternatives will be enormous and that poor choices will threaten the nation's economic stability. Cutting deficits now will ease those problems later. Cutting taxes and raising deficits as the administration's announced policies will do will only intensify the problems.

It is tempting to try to wave off such unpleasant projections, for example by pointing to the well-documented inaccuracy of forecasts. But the current deficit problem is not a forecast, but a reality. The imminent retirement of the baby-boom generation is rapidly becoming a reality. This nation is rich enough and its institutions are flexible enough to cope with both problems, but not by ignoring them, not with currently legislated taxes, and certainly not by cutting taxes still more.

#### V. A CURRENT ACTION PROGRAM: DOES THE ADMINISTRATION PROGRAM MEET THE TEST?

Against this background, does the administration's program as set forth in its 2005 budget begin to meet the challenge? The answer, alas, is that it does not. The budget claims that it will reduce the budget deficit, projected to be \$521 billion in 2004, to \$237 billion in 2009, a reduction of more than half. There are several problems with both the target and with the claimed achievement toward it.

When is a cut not a cut? The heralded halving of the budget deficit is actually an increase in the deficit relative to what the administration projects will happen if it doesn't do anything other than fund current services. Table S-14 (p. 388) of the budget reports that the unified budget deficit will fall from \$527 billion in 2004 to \$211 billion in 2009. Thus, the budget's actual commitment to reach \$239 billion amounts to a \$28 billion increase in the deficit.

Furthermore, the choice of 2005–09 as the period over which to measure progress toward deficit reduction is grossly misleading. The first baby-boomers become eligible for Social Security in 2008 and for Medicare in 2011. Extension of the expiring tax provisions of the 2001 and 2003 tax acts that the administration seeks to make permanent will affect revenues only in years following 2010. Thus, the administration claims credit for deficit reduction, while actually increasing it, over a period 2005–2009 conveniently before its own deficit-increasing policies take effect and before the commitments of past legislation inexorably drive up projected budget deficits.

The program. The administration is on record with commitments that make achievement of even this remarkably unambitious objective highly improbable.

- The administration has indicated that it will propose relief from the alternative minimum tax in 2005. Just how much such relief will lower revenues depends on how much relief is given. Sufficient relief to hold constant the number of filers subject to the AMT could lower revenues as much as \$200 billion cumulatively from 2005–09 and more than \$600 billion over the succeeding 5 years. The absence of any specific minimum tax relief from the 2005 budget means either that tens of millions of filers will not receive the tax cuts that the administration proposes to make permanent or that the tax collections will be lower and the deficit larger by the amount of such relief. The administration cannot have it both ways.

- Even the deficit reduction that is promised is partly phony. The administration has asked once again for a variety of new saving "incentives." Within the 5-year projection period they are scored as revenue increases, but they would reduce revenues by hundreds of billions of dollars in later years because all investment earnings and withdrawals would be exempt.

- Nor despite promises dating back to the 2000 campaign to restore balance to Social Security does the budget contain any specific proposal to reform Social Security. The budget does put in a good word for the recommendations of the president's own Social Security commission. Unfortunately, all the commission's three plans

would aggravate the budget problem, adding approximately \$4 trillion each to the public debt by 2040, according to official estimates the Commission reports.

A better way. In confronting a deficit problem of the size American faces, the first requirement of good policy is honesty about the size of the problem and of the steps that it will take to deal with it. Staff of the Brookings Institution tried to meet that challenge in its recent report, *Restoring Fiscal Sanity: How to Balance the Budget*. It starts by presenting an honest measure of the unified budget deficit over the decade from 2005–14. Next, it explains why closing that deficit is a vital first step to dealing with the nation's long-term fiscal challenge. Finally, it lays out three programs to achieve that objective.

- One of the programs relies primarily on spending cuts to close the deficit. It is a program designed to represent how an advocate of small government could simultaneously pursue that objective and fiscal balance.

Although this option entails expenditure cuts that many would regard as draconian elimination of all Federal spending for elementary and secondary education, housing and urban development, manpower training and related programs, environmental protection, and law enforcement, for example, as well as many other cuts spending reductions are insufficient to restore fiscal balance by 2014. It is still necessary to boost taxes by \$134 billion a year, relative to a baseline in which all of the 2001 and 2003 tax cuts are extended.

- Another program expands government spending and raises taxes enough not only to pay for that spending but also to close the deficit. It is a program that implements an activist and fiscally responsible vision of government.

- An intermediate program, which most of the authors of the study embrace, would restore fiscal balance with a combination of spending cuts and tax increases.

This study demonstrates that one need not plunge the nation into a fiscal morass in pursuit of any particular vision of government. It also underscores that it will take courage and patience to restore fiscal sanity to a policy trajectory that is badly astray. The administration's proposed 2005 budget does not meet any of these tests.

#### VI. PROPOSED CHANGES IN BUDGET PROCEDURES

Many observers warned that the expiration of the Budget Enforcement Act would remove a useful device for constraining spending and tax cuts. They have urged Congress to adopt new procedures that would promote fiscal prudence. The 2005 budget contains proposals to alter the budget process. Unfortunately, they would be neither effective nor fair and Congress should adopt quite different rules.

The administration proposes that Congress adopt rules under which any legislated increase in entitlement spending or refundable tax credits would have to be offset by cuts in other entitlement spending or other refundable credits. No restriction would apply to cuts in positive taxes. This rule contrasts with the old pay-go rules under which entitlement spending and tax changes of all kinds were grouped.

The proposed rule is not worthy of serious consideration, in my view. It is hard to conceive a rationale that would place greater procedural burdens upon spending and tax credits that primarily benefit the elderly, disabled, and households with low or moderate incomes the primary beneficiaries of entitlements while creating no obstacle to deficit-increasing cuts in positive income taxes paid primarily by upper-income households. As Alan Greenspan has stressed, one must deal both with tax and spending entitlements. By embracing such budget procedures, the administration has surrendered any right to accuse opponents of its policies of class warfare.

Under the administration's proposed budget rules, any increase in discretionary spending above the administration's baseline would require a super-majority. Some target is surely necessary. But the one that the administration proposes is not reasonable. It proposes as a baseline to hold non-defense discretionary spending constant in nominal dollars between 2004–09. This target amounts to a drop in real per capita spending of approximately 15 percent over this 5-year period. Nondefense discretionary spending would fall from 4 percent of GDP in 2005 to 3.2 percent of GDP in 2009, lower than any other year published in OMB's Historical Tables. If this trend reflected the demonstrated intent of either the administration or Congress, it might make sense, but it does not. The administration has proposed and Congress has approved gradual increases in non-defense discretionary spending. There is no indication that either wants to reduce per capita services by one-fifth. The implausibility of this projection is yet another reason why the administration's claims of reducing the Federal deficit are not to be taken seriously.

Mr. SHAYS. I am going to give Ms. Baldwin the first chance but just to clarify, what level of spending are you suggesting has taking place in the last 4 years?

Mr. AARON. I am saying the share of gross domestic product.

Mr. SHAYS. The increase. What is the increase in spending?

Mr. AARON. 1.6 percentage points of GDP of which three-quarters of that is attributable to national defense and homeland security.

Mr. SHAYS. The growth in spending has been what, on the average of about 8 or 9 percent?

Mr. AARON. It has varied. During the first years of the Bush administration, it was much higher than that. During the last year, there was a significant slowdown, virtually no increase in domestic discretionary spending in the last year, but continued as a number of members have stressed legitimate increases.

Mr. SHAYS. I will do it when I have my time but it strikes me that we are way off on our numbers, so it would be good to nail them down.

You have the floor. Why don't we do 10 minute rounds and then I will go to you, Mr. Scott.

Ms. BALDWIN. Thank you, Mr. Chairman.

I will jump in where you left off because I have seen the graph that was referred to comparing 2000 and 2004 revenues and expenditures as a percentage of GDP. The figures you used at the end are somewhat difficult to wrap one's brain around but let me see if you agree with this contention and then perhaps we can share this graph with committee members.

If you ask what share of the swing from surplus to deficit is attributable by changes in revenue policy, tax breaks versus spending, what I saw, and it doesn't matter whether you use OMB numbers or CBO numbers, it is 76 percent of the swing attributable to the change in revenue as a percentage of GDP?

Mr. AARON. I believe that is approximately the same numbers I have. The swing in revenues should be divided into two categories. We have gone into a recession. Revenue collections have collapsed for reasons that nobody clearly understands as yet. In addition, we have cut tax rates so it is a combination of the two. Actually more of it is attributable to the changed economic assumptions and revenue collections, about 40 percent of the deterioration in the budget is attributable to that, 27 percent to tax cuts and the rest to spending.

Ms. BALDWIN. I don't actually have that chart in front of me but will share with the chairman and make sure we are all on the same page with regard to these numbers.

I guess I couldn't agree more with your assessment and sort of over arching statement that this truly is about priorities. I think you were here earlier when I had a chance to ask some questions of Secretary Snow about the distribution of benefits of the tax cuts previously imposed, the impact of their extensions, making permanent the 2001 and 2003 tax breaks and also the new proposals, specifically the life savings account and the retirement savings account.

I believe it may have been some of your colleagues who took a closer look at these proposals. They have been offered before and I know the administration has made a few changes to the proposals but there are essentially things that we have seen before and have been analyzed before.

Once concern I have as I stated to Secretary Snow is that some of the short range costs are quite manageable, quite affordable, but when you look at a fully mature, up and running lifetime savings account and retirement savings account program as currently proposed, I have seen cost estimates as high as \$50 billion a year or more. I also have seen very disturbing analyses of who really benefits in our population from those programs once they are up and running, specifically the top 5 percent of the U.S. population would get 50 percent of the account's tax benefits, that the top 10 percent could secure two-thirds of the tax benefits. Additionally, that was with the lifetime savings account, that the retirement savings account might be additionally skewed.

Lastly, if you can address this in response, the Treasury Department has looked at current law and who gets to fully reap the benefits of contributions to IRAs and to 401(k)s. The Treasury Department said recently that only about 4 percent of those currently eligible to contribute to IRAs actually max out in any given year. Only about 5 percent of 401(k) participants actually contribute the maximum. I am wondering whether there is a belief that any greater percentage of people would be able to reach these maximum limits if we were to convert these two or have greater reliance on the savings programs that are being proposed in this President's budget?

Mr. AARON. I would like to make three points in response to your question. The first is I think encouraging saving is a good thing, particularly for lower income Americans. With that in mind, it is particularly distressing that the administration's budget does not call for an extension of the saver's credit which is targeted to lower income Americans. They are the ones not saving enough, who need encouragement.

The second point is that the administration and many private analysts have taken pains to emphasize the importance of looking at the long term budget challenge posed by social insurance. This is not irrelevant to your question. They look many years into the future and in effect calculate the present value of our obligations. That is an illuminating thing to do. I am not decrying it in any way.

What is sauce for the goose is sauce for the gander. If one should do that with respect to social insurance, one should also do that with respect to proposed changes in the tax code. If one does that with respect to the savings proposals that have been advanced, they represent truly enormous tax reductions. The reason they represent enormous tax reductions is that they encourage saving in a forum where the deposits are not in any way tax favored but all investment earnings are exempt and withdrawals are tax free, sort of the reverse of normal IRAs, just what Roth IRAs do.

Furthermore, the proposals would allow people to convert from the traditional IRAs which backloaded benefits into these alternative accounts counting the revenues that are collected on conversion as net additions to revenue during the 5 year budget window. As a result, they don't look like they cost much. In fact, they cost on a properly accounted basis hundreds and hundreds of billions of dollars and represent an enormous increase in the deficit burden that we will face in the future.

I think the first step is to do a proper accounting of the cost of these programs and then ask whether this is a use of the Government's tax raising capacity that meets the standards of Congress. Like you, I share the view that the benefits are skewed unevenly toward upper income households but that is where the money is and I can understand somebody arguing on the other side that if you really want to promote saving, that is the way you want to do it. If you want a net addition to national saving, however, it is important that the proposal not reduce Federal revenues dollar for dollar for any increase in private saving that occurs. That doesn't add to national saving.

The first step is to account honestly for the cost of these proposals. The second, in my view, is to pay for them. I think the general idea of pay go rules is something we ought to adhere to now and then we can have a debate about whether this is something that we think is in the national interest.

Mr. SHAYS. Thank you.

Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. SHAYS. I just want to say, Mr. Aaron, except for your last words, I have been listening to you closely because I have some real problems with what you are saying. You may be right on some of it but I need to sort it out.

Mr. Scott, you have the floor for 10 minutes and Ms. Baldwin if you want to come back and I will take 10.

Mr. SCOTT. As Ms. Baldwin pointed out, and you can see on the chart, we have had a swing of approximately \$750 billion from the surplus down to the deficit we have now. The last time I checked on the Federal budget under revenue, the line item individual income tax, everybody's individual income tax brought in less than \$800 billion. We have had a \$750 billion swing in 3 years. How would you describe that kind of deterioration in the budget?

Mr. AARON. Much of the deterioration in the budget that has occurred in the last 7 years is attributable to the causes that Secretary Snow and some of Shays' colleagues have emphasized. We have gone through a very difficult period, a terrorist attack, a need for military build-up, a need to invest in homeland security, a recession that has lowered revenues. The bulk of the deterioration in the specific budget numbers we are looking at is attributable to those causes.

My concern is that confronted with these adverse events, it would seem to me this is not an opportune time to weaken the Federal Government's revenue raising capacity for the long haul. I agree with Secretary Snow that the tax cuts we have enjoyed in the last 3 years have softened the recession. It would have been worse had tax cuts not occurred. It could have been better than it was if the tax cuts had been better designed, targeted more toward people who would have spent a larger proportion of the tax cuts that were given to them than the actual legislation did but there is no doubt that the tax legislation enacted in 2001 and 2003 have softened the recession.

Virtually all of the increase in disposable income that has occurred in the last couple of years can be traced to tax cuts rather than to increases in wages and salaries.

Mr. SCOTT. Mr. Aaron, as you know, different tax cuts have different effects on the economy.

Mr. AARON. Yes.

Mr. SCOTT. Different spending, if you are faced with the challenge that we are presented, the first thing the House did right after 9/11 was to pass legislation that dealt with the alternative minimum tax to corporations. Those corporations that are profitable sent out dividends every year that we notice weren't paying any taxes. A few years ago we passed the alternative minimum tax for corporations. Right after 9/11, we elected to repeal the alternative minimum tax for corporations and made the repeal retroactive 15 years, giving billions of dollars in tax cuts and several corporations got about \$1 billion. Enron got about \$250 million.

Mr. AARON. And a lot of good it did them.

Mr. SCOTT. It seems to me that kind of cash would do nothing for the economy. It might mean that the corporate executives get their bonuses, it means the dividends might go out but there is no new demand for product, so anybody who works for the company is no more likely to have a job after that than before.

There are other things you can do. Extend unemployment compensation, earned income tax credit, tax credits to families that would have a much more stimulative effect. On the ones that we selected, could we have gotten a substantially bigger bang for the buck in terms of the economy than we did?

Mr. AARON. I believe the answer to that is yes and I would add an item to your list of places where I think the use of Federal revenues could have much produced a much bigger bang for the buck and that is greater aid to State governments. They have been confronting very large deficits for the past 3 years as a result of which they have had to do something you don't want to have to force a government to do during a recession which is to raise taxes, and they have been forced to cut back on services, many of which flow to those who are most directly affected by the economic slowdown and to dependent populations more generally.

The most important failing in my view of the tax policy of the last 3 years is of a different kind, however. It is the fact that the clear intent is to make these cuts permanent. As Mr. Spratt emphasized with his chart, the Nation faces enormous spending challenges in the future. There is much talk about reducing entitlement spending, the net action in the past year was to raise entitlement spending.

The likelihood that we are going to reduce entitlement spending materially moving into the future is not very great. In fact, the three proposals advanced by the Commission that President Bush appointed to examine Social Security all would add approximately \$4 trillion to the national debt over the next three and a half decades. As I say, Congress acted last year to increase not decrease Medicare spending. In this environment to make permanent tax cuts seems to me to be rash.

Mr. SCOTT. One of the problems I have noted is it appears to me that there is no one sounding an alarm. If you look at this chart, it just goes out to about 2014 where you have with reasonable assumptions, listening to the President and what he wants done, including making the tax cuts permanent, you have deficits in the

\$450 billion to \$500 billion range out to 2014. At the last hearing, I reminded people of the joke about the guy who jumps off the 20 story building and at the eighth floor, he says, so far no problem.

In 2014, you have a \$502 billion deficit. That year you have a \$275 billion surplus in Social Security. Three years later, as we know, the Social Security surplus will evaporate and then it goes into deficit. Even there you are on the brink of a \$275 billion hole in the budget that has to be filled 3 years from there. Nobody seems to be alarmed by the fact that unless we have a profound change in direction, we are not going to be able to pay Social Security.

Mr. AARON. I am more optimistic about being able to pay Social Security. Actually the cash flow surpluses in Social Security will continue until the later part of the 2020s. The date to which you refer, which is about 2014 is the one at which payroll tax revenues cease to be sufficient to cover outlays of the problem, but Social Security has other revenues including from the income tax and from interest paid on the bonds which are held in the Social Security reserve.

Mr. SCOTT. Where does that money come from?

Mr. AARON. Let me continue because I think the fundamental point you are raising is absolutely right and I would like to put in a plug for an effort to respond to precisely the concern you are expressing that I was part of at the Brookings Institution. We recently put out a study which attempted to form a realistic estimate of what budget deficits would be stretching out to 2014 under the assumption the tax cuts are indeed made permanent, all of them enacted in 2001 and 2003.

It did included some relief in the minimum tax but not full relief from the minimum tax, and it included growth of domestic discretionary spending at the rate of inflation on a per capital basis. Given those assumptions which are not extraordinarily bullish, the projected deficit in 2014 was close to \$1 trillion.

What we did was try to ask how—I will use political labels—a responsible conservative, a responsible liberal and by that I mean a small government conservative and a big government liberal and somebody who was in between could respond to that deficit problem in a serious way. How could they close the deficit by 2014? We presented three different programs, one of which relied almost entirely on spending cuts but not entirely, one of which raised government spending and raised taxes enough to pay for that and the deficit, and one that cut spending and raised taxes, all of which balanced the budget.

The job is tough, that was the message of the book. The second message was it can be done if Members of Congress from both sides get together and do the job but we concluded that there was no way even with a small government mentality of doing the entire job without some tax increases.

Mr. SHAYS. Mr. Aaron, you are a very respected and I view a somewhat centrist economist, you are not on the fringe on either side, certainly not on the fringe on the supply side, but I view you as being somewhat centrist, maybe leaning a little to the left side. You are about as respected as they get. I just want to not knowing exactly how this is explained, I would like you to look at two charts

and let me first take a look at chart No. 3 in the President's budget request and just walk me through the first four 3 years, 2001 to 2002, and then 2003 and 2004.

We are looking at basically what we think is a 9.7 percent spending increase in discretionary spending. You would agree that is admittedly discretionary is only about one-third of the budget but you would basically accept we have been doing that?

Mr. AARON. I would and I would like, as a former luncheon companion of yours at Brookings, return the compliment. It is a genuine pleasure always when you come because one has a productive and honest interchange of views.

Mr. SHAYS. We have an interesting time, don't we?

Mr. AARON. Yes, we do.

Mr. SHAYS. How about looking at chart No. 2.

Mr. AARON. Before we leave, that includes—as I understand—it both non-defense discretionary and defense.

Mr. SHAYS. Correct, and it includes the supplemental. That is why you see the \$875 billion and it is what distorts what you read later. It says, the next 5 years total discretionary spending would grow at 1 percent.

Mr. AARON. No, the 1 percent, yes, you are quite right. The non-defense discretionary actually is projected to be flat in nominal dollars between 2004 and 2009. That is the same number in each year, plus or minus \$1 billion.

Mr. SHAYS. That is if we accept the viewpoint that the \$86 billion supplemental doesn't repeat itself.

Mr. AARON. No. I am referring to non-defenser discretionary right now.

Mr. SHAYS. Right. You are on one level and I am on a different level. Can we just stay with this a second?

Mr. AARON. Sure.

Mr. SHAYS. I just want to know if total discretionary, if you basically look at those numbers and say it was 664, 735, 849, 875, those look more or less like they were in discretionary?

Mr. AARON. Yes. There are some timing issues as to what goes in what year but fundamentally, we are talking about rounding.

Mr. SHAYS. And all I am doing is admitting to you that in 2005, 2006, 2007, 2008, 2009, it looks like somehow we are getting spending under control but that makes some assumptions. We have this balloon in the 2004 budget with the \$86 billion supplemental, for instance.

Mr. AARON. Yes.

Mr. SHAYS. But what I am asking is when I look at those numbers and I do see a 9.7 percent increase in terms of historic in discretionary spending?

Mr. AARON. Yes.

Mr. SHAYS. Let us take a look at chart No. 2 in the budget. This is all spending. When you talk about it growing, I see it growing at 6.2 percent and I have historically believed anytime it grows historically greater than 4 or 5 percent, we are clearly outpacing the natural growth in revenue.

When I look at that and see a 6.2 percent over the last 3 years from 2001 to 2002 from 2002 to 2003 and 2003 to 2004, what am

I missing that you see because that to me is a 6.2 percent growth in overall s pending?

Mr. AARON. I think we are talking about the same numbers in a mutually consistent way but from a different standpoint. You are pointing out, correctly in my view, that government spending has risen faster than gross domestic product, 6.2 percent per year is faster than the actual growth in gross domestic product.

Mr. SHAYS. Particularly in those years.

Mr. AARON. Yes. What I was saying is that government spending has risen as a share of total national income by 1.6 percentage points. That means, just to pull a number out of the air and I don't think these are necessarily right, if it was 19 percent in 2001, it is 20.6 percent in 2004 or 2005. Given the fact that gross domestic product has been rising in nominal dollars, and this is shown in nominal dollars, is entirely consistent with a 6.2 percent per year growth as you have shown in this chart.

Mr. SHAYS. I would love to be in one sense in the minority right now because I do think there is a lot you can rail about this budget and the budgets that have proceeded, so there is a bit of envy on my part but I do want you to know that in this room there is no much discussions about solutions on either side. Maybe we have to say uncle and then maybe both sides will start to talk about solutions. I do realize since we have excluded Democrats from the solution in some ways, we can't then say we want to hear your solutions. I am more than willing to put that on the table. We basically had to pass our budgets on our own and in part because there is a disagreement about taxes.

When I look at the information that comes to us, the biggest contributor to the deficit has been the slow down in the economy.

Mr. AARON. Yes, that is correct.

Mr. SHAYS. In fact, if we had no tax cut, we would still have a deficit?

Mr. AARON. Yes.

Mr. SHAYS. But it wouldn't be as great, is that your point?

Mr. AARON. My point is that a tax cut at this time is useful in maintaining demand and in preventing unemployment from having risen faster and further than it did. I think we need to be concerned about the fact that the tax cuts under administration policy would become permanent in the face of expenditure demands that will result in potentially catastrophic deficits.

Mr. SHAYS. You have concluded that the President's \$518 billion deficit, you believe will be over \$600 billion. Is that because you have made the assumption that we will still have to have the same additional supplemental in defense? The reason I question that is we are adding 7-plus percent to the defense budget and my logic is, that has to be going to pay for some of what we have been involved in. Otherwise, why the heck are we putting it in there?

Mr. AARON. My adjustment was not for the supplemental. I left that out entirely. My adjustment was not for the supplemental. It was simply on the basis that I think it is not wise to count the cash flow surplus in Social Security and in Medicare hospital insurance as legitimately used to pay for current government consumption.

Mr. SHAYS. Surplus is something I need to have you define.

Mr. AARON. It is the difference between total revenues and total expenditures in Medicare and Social Security, Medicare hospital insurance.

Mr. SCOTT. We pay more into Medicare than we pay out.

Mr. AARON. Let me put it this way. The unified budget has three pieces. It has a surplus in Medicare, a surplus in Social Security, admittedly in both cases temporary, and Medicare hospital insurance, and a deficit in everything else that government does.

Mr. SHAYS. And you are saying it is disguising the deficit?

Mr. AARON. What I am saying is if you really want to look as you would in a business at sort of what current operations.

Mr. SHAYS. I understand you now. You are basically saying we are counting Social Security reserves and Medicare reserves and we disguise the deficit and I think that is legit.

Mr. AARON. Yes. Let me say, I found your previous remarks very heartening. I think that the message that has gone forth to the Nation and that is still going forth from many quarters is there is a deficit, don't need to worry about it, the long term will take care of itself, we can't trust forecasts, they are wrong all the time, why worry.

The message that I was trying to convey in my testimony that the Brookings project to which I referred earlier was trying to emphasize and I think I am hearing more and more in statements from journalists and I think abroad when I hear people interviewed, and I think it will come to be heard from the halls of Congress, is that we face a very serious long term fiscal challenge. It is a challenge to both parties, it is going to take spending cuts, it is going to take tax increases. The longer we deny it, the harder the problem will be. We don't, and here is where the partisan disagreements come in, we don't begin the process of dealing with it by making permanent and enacting yet additional tax decreases at this time.

I fully understand that Congress is probably not going to roll back all of the tax cuts.

Mr. SHAYS. On either side of the aisle.

Mr. AARON. On either side of the aisle, I understand that. I listen to the Democratic candidates for nomination and I hear the same thing you do but I think it is important to begin to understand that the Nation faces fiscal challenges for pensions, for health, for national defense, for everything else that government does that cannot be satisfied on a tax base in which all of the tax cuts that have been put on the books in 2001 and 2003 are fully renewed and more tax cuts are enacted besides. The numbers don't add up.

Mr. SHAYS. I just want to ask you this. There are some on my side of the aisle who think that the logical compromise is to restore, I am not saying this is unanimity, but to deal with the tax cuts that are coming due in 2005, extend those and wait and let the next Congress and whoever is the next President deal with that issue. It may be then we continue on our route but we will have a clearer picture.

Mr. AARON. The Hippocratic oath is "primum no nosari," first, do no harm.

Mr. SHAYS. Right. Let me ask you this. I will wait for my second round but I would be asking which tax cuts do you think are the

most healthy and helpful. My biggest challenge is understanding the total elimination the inheritance tax. My constituents who are very wealthy, many of them, have argued to reduce the tax rate from 55 to 25 and increase the threshold from say \$1 million say tenfold or twentyfold but they have never argued for total elimination, never, at least not mine.

Mr. AARON. There is a case where current law returns us to the situation in 2001.

Mr. SHAYS. But that is pretty absurd, total elimination, then total continuation.

Mr. AARON. Absolutely.

Mr. SHAYS. Mr. Scott, you have the floor.

Mr. SCOTT. Thank you, Mr. Chairman.

I agree with you that when you talk about cuts can help, it is not any tax cut, the right tax cuts can help the most. Any tax cut might help or might not but you have to make sure you are doing them in an intelligent way. If you are talking about stimulating the economy now, a backloaded, permanent tax cut is not the right thing to do. Is that right?

Mr. AARON. In my opinion, no. I am agreeing with you. No, it is not the right thing to do.

Mr. SCOTT. We had a chart that showed that in terms of job creation, this administration is the worst. The chart went back to Harry Truman. Everybody created jobs during their administrations, nobody left office with fewer jobs than they came in with and that period of time, included the Korean War, the Vietnam War, the cold war, hostages in Iran, Kosovo, Grenada and everything else. This administration is not doing as well as anyone in the last 50 years.

It seems to me that when you talk about 9/11, an argument in my judgment could be made that was an opportunity to stimulate the economy and if you did it right, in fact, you could have stimulated the economy. Instead, we gave cash to airlines, alternative minimum tax and that kind of thing. If you had taken the money we spent for 9/11 in hiring police officers, port security and construction in ports, and that kind of thing, you could have actually increased the national security and created jobs at the same time. Is that right?

Mr. AARON. Mr. Scott, I do not want to disagree with that characterization of history but personally I believe the really important thing is to look ahead. Right now, American workers are exhausting their unemployment benefits at the highest rate in recent decades. I think it is imperative if this is a jobless recovery which, so far, it has been, it may turn around and I pray that it does, but if it is a jobless recovery so far, then I think it is important as part of the program of combating the effects of the recession and at the same time putting purchasing power in the hands of the American public to fight the recession itself to provide extended unemployment benefits that are not being offered, will now expire.

Mr. SCOTT. What would that do for the economy?

Mr. AARON. It does two things. First, and I think most importantly, it helps the people who are exhausting unemployment benefits maintain their payments on home mortgages and payments on automobiles and be able to continue a normal pattern of living. In

addition, it maintains consumption at large and that creates additional jobs.

Mr. SCOTT. In terms of bang for the buck, putting money into extending unemployment benefits, what kind of bang for the buck do you get for that compared to eliminating the tax on dividends?

Mr. AARON. The evidence on that is that eliminating the tax on dividends will have some modest positive effect on consumption. It is not zero but the bulk of those benefits accrue to individuals who consume a much smaller proportion of their income than do those who are scraping against budget limits because they don't have a job.

Mr. SCOTT. So in terms of bang for the buck and stimulating the economy, we ought to do unemployment compensation extensions before we think about dividend cuts if our goal is to stimulate the economy?

Mr. AARON. I would certainly do the unemployment extension. The issue of dividend cuts I think raises much more complicated issues of tax policy. The way in which we tax dividends and corporate source income is a mess. Some income is taxed twice, some is not taxed at all and some is taxed once. The objective, in my view, should be to tax all corporate source income once, not twice, but not zero times either. What I think is needed is a different form of reform of the taxation of corporate source income than the one that was enacted but not no action at all.

Mr. SCOTT. One of the problems you mentioned, me worry kind of thing, I view it as the Alfred E. Newman approach to the budget, I do not get the sense that there is an alarm. I mentioned the fact that the swing in the deficit we see is equivalent to the entire take on the individual income tax and it is an easygoing kind of response to that. When you look at 521 deficit and getting worse and you have the Social Security coming around the corner, it is a kind of lackadaisical response. Then you have people wanting to cut spending a little bit. You saw the last chart where the discretionary spending was \$800 billion to \$900 billion. Half of that is defense. If you just talk about non-defense discretionary spending, you are talking about \$400 billion to \$500 billion. In other words, if the Appropriations Committee did not meet after they funded defense, did not appropriate a dime after that, you still would not be in balance.

Mr. AARON. What you are characterizing is the size of the deficit. What disturbs me most right is what I think is a mischaracterization of views on the deficit. I was on a radio program yesterday with another economist who said, opposing the deficit is a job for the minority party. Whoever is out of office, they complain about the deficit because it is a problem of those who are in office.

I thought about that and I think that is wrong. Back in the 1980s, as I recall, it was both Republicans and Democrats that were badly worried about the deficit. They thrashed around for a while trying to find budget procedures which did not work; they talked about various cuts; they did not really belly up to the bar and take the necessary actions to deal with it, although there were some tax increases and domestic discretionary spending was reduced significantly during President Reagan's term in office. We

had as bad a problem at the end of the decade but both parties agreed that there as a problem, the ins and the outs.

I believe that consensus persisted throughout the 1990s and ultimately it bore fruit, a combination of courageous bipartisan policy and good luck gave us budget surpluses and now, in my view, a combination of very bad luck and unwise policy has given us large and indefinitely projected deficits. I would like to see a return to this bipartisan consensus that deficits are a problem and that we need to deal with them.

Mr. SCOTT. I would just take issue with your view of history and we can debate it. Let me just give you another version. When President Clinton came in for 2 years there was no Republican vote on the budget. All that was heavy lifting was done without a Republican vote. When the Republicans came in, the first thing they did was pass a trillion dollar tax cut that President Clinton vetoed, they closed down the Government because he wouldn't sign the bills, but because he kept vetoing irresponsible budgets from the majority, that kept the fiscal responsibility and that allowed that green line up to 236. It is only because President Clinton kept vetoing their irresponsible tax cuts. When President Bush came in, they passed the same thing, it wasn't anything new and you see what happened.

Let me ask, do you know how much the Nations saves, if you add up all our savings, what it amounts to?

Mr. AARON. The national savings rate is in the vicinity of five to 6 percent of gross domestic product of which only a very small part is done by households, most is done by business.

Mr. SCOTT. What number is that?

Mr. AARON. You mean in billions of dollars? It would be \$700 billion to \$800 billion. I would like to correct that number for the record.

Mr. SCOTT. We are trying to borrow \$500 billion this year. So if everybody put every dime of their savings into government notes, we wouldn't make it. The fact is much of the Government borrowing is borrowed from foreign governments?

Mr. AARON. That is exactly right. We are incurring additional debt by importing more than we are exporting, that we owe abroad, and we are diverting private saving that could go into new factories to increase worker productivity into paying for current Government services.

Mr. SCOTT. China buys a lot of our debt. My question is, does that create a national security problem?

Mr. AARON. I think the only national security problem that the Nation faces is if the amount of debt outstanding becomes so large—there are two ways. If the amount of national debt outstanding becomes very large so that the interest burden begins to represent such a large drain on current spending that we cannot responsibly afford other things the National needs, national defense, pensions, health and the like without highly distorting tax rates. The other danger is if the share of American assets held by foreigners, not just government debt but private securities as well becomes so large that at some point a change in foreign sentiment about holding U.S. debts could create a very serious crisis in finan-

cial markets in which that debt is traded. The larger our debt held abroad, the greater that risk becomes.

Mr. SCOTT. Mr. Chairman, if I could say the problem there is that if we are trying to negotiate something with China and they hold billions of dollar of our paper, part of the negotiation could be to our negotiators, if you don't accept our last offer, we are going to start selling our paper, that could affect the negotiations. When we continued the war in Iraq at \$87 billion, we had to borrow \$87 billion to continue the war and in 2009, interest on the national debt, if that green had continued as we projected, would have been zero, will be according to CBO approximately \$300 billion. Three hundred billion dollars at \$30,000 apiece could have hired 10 million people working—talk about stimulating the economy. For \$300 billion, you can hire 10 million people, only 9 million are unemployed. Borrowing has had a devastating effect on our ability to meet our needs and the amount of debt we are piling up and the rate we are piling it up and the direction in which this red line goes ought to result a different response than kind of business as usual.

Mr. SHAYS. I am finding this very interesting. One of the things I do want to put on the record, because I was part of the Budget Committee during the 1990s, is I always felt that the President basically wanted to spend more, basically the equivalent of what we wanted in a tax reduction, so I always took the view that it really was pretty much a wash. We wanted a tax cut and he wanted to spend more and it was a difference in philosophy.

Some of the spending I actually liked but I do want to put on the record, Mr. Aaron, that in 1997 we had a significant tax cut but we also slowed the growth of spending to 1 percent for 1 year. We then worked on a slower base. My view was that the market looked at this and said, they had a tax cut that was significant, a long list, many, many pages, the Taxpayer Relief Act of 1997, child tax credit, education tax incentives, the savings and investment tax, the alternative tax provision, the estate gift and generations gifting tax provisions, extension of certain expiring tax provisions, miscellaneous provisions, the capital gains, the welfare to work tax, it goes on, but it wasn't an insignificant tax cut. My recollection is that when we wanted to get to of town, we always had to spend a little more than we wanted.

What we did do was we had a tax cut and we slowed the growth in spending. I thought the market responded to that and said, these guys are serious. What I have heard you and others say is you almost feel like we are oblivious to this and you need to see a message that we are aware of the future implications.

One of the things we didn't want to be was like President Hoover, cut spending, raise taxes. We weren't going to fall into what we think was the traditional Republican trap and that may have scared some folks. It was obviously made easier by the fact that we had some very real spending on national security. Did that tax cut not exist or am I inventing it or did it?

Mr. AARON. Let me be clear on the history as I was trying to explain it. I think the United States for about a decade and a half, allowing for politics and for pulling and hauling and perhaps some irresponsible intents on both sides of the aisle, was blessed by un-

usually good overall economic policy. I would date the beginning the enactment of the Tax Reform Act of 1986 which was put forward under President Reagan, supported by him, and passed by a Democratic Congress.

Mr. SHAYS. That was pretty much a tax cut though.

Mr. AARON. No, it was basically revenue neutral. That was the goal, to make the bill revenue neutral, so it was not a tax cut.

Mr. SHAYS. I know that was the goal but was it actually a tax cut?

Mr. AARON. It ended up reducing taxes somewhat as I recall on businesses—pardon me, erased slightly on businesses and reduced them slightly on individuals but I believe in the end it was close to a wash.

Mr. SCOTT. Mr. Chairman, didn't it do something about Social Security at that time too?

Mr. AARON. In 1983, there was major legislation on Social Security following the Greenspan Commission which made recommendations for change. We could date it from that if you will as well, but then in 1990, President Bush and a Democratic Congress passed the first of three important deficit reduction measures.

Mr. SHAYS. Let me make a point there. I regret voting for that tax increase because I remember I voted for the luxury tax and truly your point, there are some taxes that bring in less revenue when you increase them. They just stop spending and we put the boat industry out of business.

Mr. AARON. I think that was in historical view and perhaps it should have been in prospect, a mistake but it was a small element of what was overall a beneficial package for the economy. Then in 1993, President Clinton with a Democratic Congress, and as Mr. Scott says, with no Republican support, enacted a second deficit reduction package. Then in 1997 through whatever process of pulling and trading actually occurred, a Republican Congress enacted a major deficit reduction package that was signed by President Clinton with some tax cuts but with significant spending restriction and it contributed to deficit reduction.

What I am saying is that over that period, from 1986–97, not necessarily in an eager, attractive way, it is like making salami and you don't want to see it but the product that came out of the end of that sausage maker for that 11-year period was a set of important economic pluses for the United States. What I am mourning is the loss of the bipartisan agreement that moving on the deficit was important. Until that is restored, and it is going to take presidential leadership that is not in evidence at the present time, until that is restored, I think the lack of concern that Mr. Scott has deplored, that you have clearly I believe indicated you are concerned about the deficit and the need for action on it, until that bipartisan consensus is restored, we have a very serious problem.

Mr. SHAYS. Let me just tell you though, I had finished what had happened from my view from 1997–2000 and that was we had these incredible surpluses, we started to actually have balanced budgets without counting Social Security reserves, and we started to go on somewhat of a spending binge.

Mr. AARON. That was I believe in part because the budget procedures were allowed to expire and were not extended. For that reason, I think extension of a balanced set of procedural rules to help stiffen the back of those who are interested in fiscal responsibility should be a high order of congressional business.

Mr. SHAYS. That gets me to kind of my last point. One of the views of some members, and I am one of them, is that before we increase the debt ceiling, that the only way we agree to it is if we see some of those pay go kinds of provisions that we used to have. Would that be something you would want to encourage?

Mr. AARON. Very much so. I think it is very important how they are designed and as I said in my testimony, I do not believe the specific proposals put forward by the administration are worthy of support but a sensible set of rules to restrict both spending and tax cutting of all kinds in an equitable and balanced way would be of great assistance in my opinion.

Mr. SHAYS. This is to be continued. I appreciate you being here. You may have liked more people here but frankly, I am kind of happy it was just the few of us.

With that, I will adjourn this hearing. Thank you so much.

Mr. AARON. Thank you.

[Whereupon, at 5:34 p.m., the committee was adjourned, to reconvene at the call of the Chair.]

